

AIRLINE CONCENTRATION AT HUB AIRPORTS

HEARING BEFORE THE COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE ONE HUNDREDTH CONGRESS

SECOND SESSION

ON

AIRLINE CONCENTRATION AT HUB AIRPORTS

SEPTEMBER 22, 1988

Printed for the use of the
Committee on Commerce, Science, and Transportation

U.S. GOVERNMENT PRINTING OFFICE

91-805 O

WASHINGTON : 1989

5261-26.

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AIRLINE CONCENTRATION AT HUB AIRPORTS

THURSDAY, SEPTEMBER 22, 1988

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC.

The committee met at 9:34 a.m., in room SD-562, Dirksen Senate Office Building, Hon. Ernest F. Hollings (chairman of the committee) presiding.

Staff members assigned to this hearing: Steve Palmer, senior professional staff member; Carol Carmody, professional staff member; and Patty Hahn, minority professional staff member.

OPENING STATEMENT BY THE CHAIRMAN

The CHAIRMAN. The committee will please come to order.

The thrust of our hearing today, at the initiative of our ranking colleague, Senator Danforth, is increasing airline concentration at hub airports. Airlines at these air hubs now, in effect, have developed a monopolistic sense over the cost of air travel.

I have a statement which I will include in the record. I really want to yield to Senator Danforth. We are familiar with the GAO report that he requested on hub airports. We will go into that very thoroughly.

In addition to hub airports and the effect they have had, Mr. Secretary, what I am going to get into also to some extent—and we will have a study on this by GAO as well—is the general feel that under deregulation, the medium-sized towns and communities in America are subsidizing the large hauls between major cities. Affordable service is no longer there for people in these communities.

This was my main concern talking with then-Senator Cannon and the committee chairman—that I come from a state that does not have a Las Vegas or a Los Angeles, and I am concerned about Greenville, Columbia and Charleston, good-sized towns, but not a hub. That is the case at a majority of cities throughout America, overwhelmingly so.

I find that my fares have zoomed up, up, and away. My service has gone down. I used to have three direct flights from Charleston each day to Washington National and three back.

Only with some help from our Piedmont friends recently were we able to get a direct flight, and that is just one. We have not gotten back, in other words, to the level of service. And, in preparation for this hearing, I pulled my tickets to South Carolina.

For example, in 1977 the fare from Washington to Charleston, South Carolina, 530 miles, was \$120. In 1988, I have the ticket stub with me just from last month, it is \$510; \$510 instead of \$120.

I know I can go to the next county and fly all the way to Miami, 500 miles farther, for less than \$100, and I get there an hour and a half sooner. That nettles me every time I go on these weekends.

Then I took a trip to Greenville, which is even again a little closer, and from Washington to Greenville and back to Washington National is \$538. By the way, this is all tourist class; this is not first class. That was just last month in August, and the other one also at that time.

You can go out and try to buy a ticket this morning, I am sure that is what it will be. We have seen fares go up, up, and away.

Of course, you can get from New York to Los Angeles for \$258 on a discount fare, which is almost 3,000 miles.

This is the kind of thing that, in your comments today about the hubs, the Committee wants to keep in mind, because it could be that if we were to consider reregulation, that we would do it on a mileage basis. If you go further, you pay more, because it is getting prohibitive, particularly on the small connector flights, where they are supposed to have some kind of competition.

The airlines could care less. To get from Charleston up to that hub in Charlotte costs as much as to get from Charlotte up to Washington, substantially further, or from Greenville. People toy with it, and right now they are beginning to drive their cars all the way from Greenville or from Columbia—it is a little too far from Charleston to get up there.

I experienced this. I do not want to belabor the committee and our attendance this morning on something that seems personal. It is uniform, and the other Senators talking are experiencing the same things all over the country.

So I will conclude my statement for the record. Let me yield to our distinguished colleague who brought this to our attention and has prompted a thorough study of the problems at hubs. Senator Danforth.

OPENING STATEMENT BY SENATOR DANFORTH

Senator DANFORTH. Mr. Chairman, I want to thank you for your characteristic consideration of the members of your committee in calling this hearing on a timely basis.

Back in 1978, Congress deregulated the airline industry. I supported that measure and believed that it made good economic sense. The theory that Congress had in mind when we voted to deregulate airlines was that, where possible, the free market system should be permitted to work and that competition was a better system than regulation.

So we believed that competition would be the substitute for regulation. That remains my basic economic premise, although concerns have been raised that, in certain airports in particular, competition does not really exist, that particular airlines have a lock on the airports and that when they get a lock on the airports they are able to do pretty much what they want.

Several years ago, I began receiving numerous complaints from constituents about the situation at Lambert in St. Louis. Lambert since the merger between Ozark and TWA has been dominated by

TWA. 82 or 83 percent of the passengers at Lambert are traveling TWA.

The concern that was raised by my constituents was that they thought that the cost of traveling had gone up very dramatically. I did not want to rely on anecdote alone for that conclusion and therefore I asked the General Accounting Office to make a study of fares at Lambert before and after the merger between TWA and Ozark.

That report was received two days ago and it is now the subject of this hearing.

Other airports have also experienced the kind of concentration that we have had in St. Louis. Minneapolis is one, Pittsburgh is another, Memphis is another. So the concern before us today is whether competition is truly working, and if it is not working then what are we supposed to do about it.

I do not think that Congress can create a situation, as we did when we deregulated airline transportation, and then just watch matters fall apart. So the question is what are we supposed to do about it?

Do we go back to regulation? I would not propose that. Do we set up some sort of contingent regulation for airports that are pretty much controlled by one airline? If so, how do we do that?

Or is there some way or perhaps some series of ways in which we can better assure competition, and access, at the airports that are now dominated by the airlines?

That is the purpose of the hearing. I want to express my appreciation to the General Accounting Office for the work that it has done. I also want to express my appreciation to Secretary Burnley for his attention to this matter and for his presence today.

The CHAIRMAN. Senator Pressler.

OPENING STATEMENT BY SENATOR PRESSLER

Senator PRESSLER. Mr. Chairman, I join in those remarks. I think this is a very critical hearing in the sense that it, along with the GAO study, will bring to light some very serious problems.

I understand that close to 80 percent of the flights in and out of one airport in my colleague's state are controlled by one carrier. I am told that at the Minneapolis airport close to 80 percent of all the flights in and out are controlled by one carrier.

Also, adding to what my friend Senator Hollings has said, in South Dakota if you fly from Aberdeen to Rapid City it costs \$269. That is to fly 150 miles. If you fly from Washington to Los Angeles, 3,000 miles, it costs \$239. So it is cheaper to fly across the nation than it is across South Dakota, and that is a very bizarre result.

The captive traveler, someone who has to go to a funeral or someone who has to go to a business meeting unexpectedly, is paying very high rates if they are in an area like upstate New York or smaller cities and towns in certain areas of the country.

I think that our smaller cities and towns are really suffering. I did not happen to vote for airline deregulation, but it passed. But I think we have to think of some reregulation, perhaps relating the cost of the ticket to the number of miles traveled.

I also think we have to take a very close look at the monopoly-like power held by certain carriers in the large airports. We do have an interest in a nationwide transportation system.

Recently I read a law review article about the need for universal service in certain areas of communications. It helps our country, it helps business, it helps national defense. It helps us in a number of ways.

The same thing is true of our national transportation system. What is happening in the airlines is going to come to a crisis with the American public soon, because there are some problems arising that Congress should foresee and head off.

So I very much appreciate the scheduling of this hearing, I think travelers in the State of South Dakota have suffered more under this scheme and potentially will suffer more than perhaps the citizens of any other state.

The CHAIRMAN. Senator Kassebaum.

OPENING STATEMENT BY SENATOR KASSEBAUM

Senator KASSEBAUM. Mr. Chairman and Secretary Burnley, I think this is a very important hearing. I think it was Yogi Berra who was supposed to have said "This is deja vu all over again," when just two days ago in this room the Commerce Committee at a hearing had a business session considering legislation dealing with market dominance of the railroads.

In many ways, I think the case is very similar, because it is an attempt to analyze what deregulation has done and what role we should play in making sure competition continues to exist.

Since deregulation we have had mergers occurring rapidly during the time we were trying to adjust to a system of hubs. The question has become one of ensuring adequate capacity, so that competition can be allowed to flourish and entry into these markets can be made possible.

We have struggled with the question of the buying and selling of slots at high density designated airports. I share Senator Danforth's concern because many of us have been held captive at hubs, and I think it is a good thing because we can appreciate some of the problems passengers experience.

I do tend to think it is more a question of capacity, not only of the air traffic control system, but of the airports' ability to expand enough to allow effective competition. Senator Danforth said, is competition truly working, and I think we have to ask ourselves that question in all areas of transportation where deregulation has occurred.

So thank you, Mr. Chairman, for calling this hearing.

The CHAIRMAN. Thank you, ma'am.

Senator McCain, do you have a statement?

OPENING STATEMENT BY SENATOR MCCAIN

Senator MCCAIN. This hearing has been called to study the recent effects of deregulation on the airline industry—specifically, the concentration of traffic at certain hub airports. I don't think anyone would argue that deregulation, on the whole, has been beneficial. However, there have undeniably been some problems, and I

believe many of these difficulties can be related to the use of hubs. The effect on our aviation system capacity and on safety, as well as the continued consolidation of the airline industry concern me deeply.

The use of hubs has brought air service to many communities which otherwise might remain unserved, and generally allows carriers to serve more origin and destination points, all aims of deregulation. However, deregulation was also intended to open the airline industry to the entry of new firms. And indeed, many new airlines did crop up in the first few years after deregulation. Yet of the 119 carriers that entered the market between 1978 and 1986, only 35 were left at the end of 1986. For the past few years, new airlines have found most markets effectively closed.

A new airline entering the market would obviously prefer an existing busy airport for a hub, because these areas offer a wide variety of connections, as well as substantial traffic. However, hubs already exist in most of the logical transfer points that produce significant local traffic. Furthermore, the markets at these hubs are already dominated by one or two major air carriers, who can commonly claim over 60 percent of the hub's traffic. Of course, these airlines are reluctant to allow further competition in their established markets. Through their control of slots, computer reservations system, and terminal counter space, they are well situated to effectively limit any attempted new entry.

As you know, one of my major concerns has been the slot allocation system, and legislation was attached to the Department of Transportation Appropriations bill which calls on the DOT to study and make recommendations on how the system can be improved. I won't belabor the subject again here, but the current slot sale process gives obvious advantage to those airlines already operating in the airport and denies access not only to new entrants but also to competitors.

I am also very concerned with the operation of the Computer Reservation System. The majors often also control the computer reservation system at a hub. In St. Louis, the focus of the GAO study we will be discussing today, TWA's CRS has a market share of 77 percent. The situation is similar at most of the other hubs, with the American and United systems accounting for 75 percent of revenues nationwide. This matter has been discussed in previous hearings, and earlier this year, the DOT completed a study into the CRS market. The GAO has also researched this issue. Clearly, there are substantial problems in the CRS industry which need to be addressed.

In addition to its effects on the industry, hubbing also has a serious impact on the safety of our nation's airspace system. Over half the passengers arriving and departing from any given hub are making connections and going on to a further destination. Typically these passengers make their transfers within thirty to forty minutes, and in three waves in the morning, at noon, and in the evening. Because arrivals and departures must be tightly scheduled during these peak hours, congestion and delays often result. The airlines must coordinate the activity of countless employees and hundreds of planes with considerable precision.

This pressure leaves very little turn around for inspection, maintenance, and rest or change for the pilot and crew. The margins of safety are apparently being eroded. Maintenance may be especially difficult at smaller spokes where equipment and facilities may be less than adequate. Pilots are flying longer hours with less rest. We may be seeing the results of these factors in some of the recent airline disasters.

These are only a few of the problems associated with the development of the hub and spoke system. I am pleased by the new emphasis on human factors and their relationship to safety. It is imperative that they be addressed as quickly and effectively as possible, and I look forward to today's discussion.

The CHAIRMAN. Senator Kasten.

OPENING STATEMENT BY SENATOR KASTEN

Senator KASTEN. Thank you, Mr. Chairman. This is an important hearing to consider the impact of the hub phenomenon which has developed in the airline industry. During the development of the hub concept there have also been a wave of mergers that have affected the millions of passengers who use our air transportation system, often quite adversely for a period of time.

Many airports, including St. Louis and Milwaukee, have witnessed the concentration of service resulting from mergers, and resulting service deterioration. Though in many areas it seems that improvements are being made, I am concerned by one airline controlling almost 50 percent of the passengers, when the next largest competitor handles only about 10 percent.

I am interested in hearing the discussion of fare levels and fare increased at these concentrated hub airports. I recognize that the larger GAO study on hub impact will not be completed until next year, but this inquiry is timely given the study of the St. Louis example.

Of particular concern to me is the ability of new entrants and limited incumbents at the major hubs such as Washington National and LaGuardia to continue to grow given the slot allocation problem at these airports. Some of these airlines have developed the kind of quality service we should expect, have gained a dedicated following because of this service, and yet find themselves unable to expand to some of the most important hubs or markets in the U.S. I will continue to work on this problem and encourage DOT to note the rulemaking mandate in the Transportation Appropriations bill in this regard.

Thank you, Mr. Chairman for calling this hearing and exploring the many interconnected issues involved.

The CHAIRMAN. Thank you.

Mr. Secretary, I note that you have a very comprehensive statement. We have three individual presentations and two panels, and the committee is somewhat constrained. The statement will in its entirety be incorporated into the record. You can deliver it in its entirety or highlight it as you wish.

**STATEMENT OF HON. JAMES H. BURNLEY IV, SECRETARY,
DEPARTMENT OF TRANSPORTATION**

Secretary BURNLEY. Thank you, Mr. Chairman. I am very sensitive to the time problems of the committee and I will try not to aggravate them. Because of the great importance of this issue and because of the very widespread misunderstanding about what has and has not happened, particularly with respect to mergers, I hope the committee will forebear with me, to run rapidly through the statement so that we have that full text before the committee for further discussion.

And I am pleased to be here today to discuss the economic structure of the airline industry.

Before I get into that, Mr. Chairman, if I may, let me inform the committee that today the FAA will send to the Federal Register a new rule designed to enhance airline safety by attacking one of pilots' and passengers' greatest fears, and that is windshear. I wanted you to know about the rule since it will be out today.

Windshear conditions, as we all know, occur when there is a sudden change in wind speed or direction, which is especially hazardous on takeoff, when the pilot has got a lot less room to maneuver.

I think we all also know, but may not realize the extent to which, this phenomenon is quite deadly. It has been blamed for more than 500 deaths in at least five fatal crashes in the last ten years alone.

This rule that we are putting out today will require the large airlines to install equipment that will warn pilots when they encounter unexpected low altitude windshear situations and will provide the pilots in the cockpit with information they need to escape safely from that windshear condition.

The rule will also require the airlines to provide their flight crews with extensive additional training in recognizing windshear and in operation of new equipment.

I just wanted you folks to know about that.

It has been a decade since the Airline Deregulation Act of 1978 became law, and during this period airline travelers I believe quite clearly have benefited enormously from the price and service options produced by economic deregulation. Between 1978 and last year, emplanements grew from 275 million to over 450 million, and that is an increase of 64 percent.

Today, according to a Gallup Poll, roughly 72 percent of our adult population has flown at some point during their lives, and only 20 years ago only 20 percent had flown during their lifetime.

In terms of social policy, Mr. Chairman, airline economic deregulation is one of the greatest populist reforms in this country since World War Two. Now, according to the Department data, average fares adjusted for inflation in this country have declined—and I want to emphasize that, have declined—13 percent since 1978 through this June, making air travel for most Americans a bargain.

Today over 90 percent of all airline passengers are traveling on a discount fare, and that is up from 48 percent before economic deregulation. And even with the mergers that did occur in the mid-

1980's, a recent Congressional Budget Office study concluded that most city-pair markets are more competitive today than they were in 1983.

In fact, the average number of air carriers serving a city-pair market has grown from 2.4 in 1983 to 2.5 last year. Between 1978 and this year, the number of city-pair markets receiving single plane service from two or more carriers—in other words having competition—increased from 1266 to 1869, and that is a gain in just ten years of 45 percent in competition.

Moreover, an average of more than 15 carriers provided service at the ten most concentrated large hub airports.

Now, these trends represent a substantial improvement over the last decade in overall competition in the airline industry. And we are also seeing the emergence of high frequency, almost shuttle type service among the major hub airports.

TWA, for example, has 21 flights a day from its St. Louis hub to Chicago, 18 flights a day to Washington, and eleven to Los Angeles. Northwest, United, Continental, and Eastern have similar service patterns radiating from their hubs.

A Brookings Institute study estimates that lower fares and better service saves airline passengers billions of dollars annually, in fact an estimated \$11 billion in 1987 alone, over what would be the case if CAB regulation had continued.

And as commercial traffic has increased, so has the industry's safety record, and this is an important point. In the first nine years of economic deregulation, fatality rates have declined 48 percent for the major carriers compared to the last nine years of economic regulation, and the fatality rate for commuter carriers has dropped 36 percent during the same period.

As you know, safety has not been deregulated and we continue to issue new safety regulations that should further enhance this record.

But to say that airline deregulation has worked well overall is not to say that it has worked exactly the way many analysts and policymakers believed it would. Competition is a dynamic process.

Certainly, the efficiency and service benefits of hub and spoke route networks have proven to be even more important than was once thought to be the case. The proliferation of fare and service options has been greater than many believed possible. And few predicted accurately ten years ago the precise evolution of the industry's structure.

Mr. Chairman, in the last few years the Department has reviewed 21 airline mergers and acquisitions, and we have done so pursuant to section 408 of the Federal Aviation Act, using authority assigned to the Department by Congress in the Civil Aeronautics Board Sunset Act of 1984.

Now, you will recall that we had urged Congress during its consideration of that legislation to give responsibility for airline mergers to the Department of Justice. We renewed that request just last year. But in neither instance did we receive a sympathetic hearing.

The 1984 Act, however, does provide for the sunset of section 408 at the end of this year, and airline mergers will thereafter be reviewed by the Department of Justice using the same process that is applied to other industries.

Now, under section 408 the Department has been required by law to approve a merger unless it is likely to lessen competition substantially or is not consistent with the public interest. That statute explicitly states that the burden is on the opponents to show that a merger should not be approved.

When we ask whether a merger will substantially lessen competition, what we are really asking is whether the merger will give the carrier the power to raise its prices or reduce service below competitive levels.

As you can see from this chart over to my left, five of the cases the Department reviewed involved a jet operator acquiring a small regional air carrier. And on those five cases, we received only the most minor of objections to the transactions involving USAir and Pennsylvania Commuter, Piedmont and Empire, People Express and Britt, Presidential and Key Airlines, and Alaska and Air Horizon.

Since there was no significant overlap in service between the major and the regional carriers in each of these instances, there were not any competitive issues.

Another five of the mergers we approved involved financially failing companies, and those include Midway-Air Florida, Southwest-Muse, United-People Express/Frontier, Texas Air and People Express, and Braniff-Florida Express.

United and People Express applied for and received an exemption from the requirements of section 408 to allow United to purchase certain assets of People Express and its Frontier subsidiary.

In the Midway-Air Florida and Southwest-Muse mergers, Air Florida and Muse were in serious, in fact it would be more correct to say terminal, financial conditions.

In the Texas Air-People Express case, you will recall that People Express was in such economic distress that in its final weeks as an independent carrier it was selling tickets below its variable cost. In other words, it was knowingly selling tickets at a loss simply to generate cash.

In each of the five mergers in this category, the issue was whether the failing carrier would be allowed to merge or be forced to go out of business, and in each case we decided that preserving jobs and service was in the public interest.

Now, of the remaining eleven applications, six involve end to end mergers of large jet carriers, and these six mergers, which included People Express-Frontier, United-Pan Am Pacific Division transfer, Alaska and Jet America, Delta and Western, USAir and Pacific Southwest, and American and Air California, raised no significant competitive issues and were unopposed by the Department of Justice.

In fact, only one of the mergers in this category, the transfer to United of Pan American's Pacific Division, generated any controversy whatsoever.

I remind you again, the statute requires us to approve merger applications unless there is substantial opposition, and the burden of proof is on the opponents. And there was no controversy at all with respect to all but one of the mergers in this category.

On that transfer of the Pacific Division, the Department of Justice said that we ought to take a look at reassigning one West Coast trans-Pacific gateway, and we agreed to do so.

Now, the remaining five mergers generated varying degrees of controversy, and these are Horizon-Cascade, Northwest-Republic, TWA-Ozark, Texas Air and Eastern, and USAir with Piedmont.

In these cases, the applicants served several of the same city-pair markets. In the Horizon-Cascade merger, the state of Washington initially expressed some reservation, but it did not object when we announced our tentative approval of that merger. In fact, this merger application could be classified as involving a financially failing company, since Cascade stopped operating before the merger was consummated.

Texas Air's proposed acquisition of Eastern raised several very serious competitive issues, and we initially turned it down. The problem was that the merger would have given Texas Air control of the only two shuttle services, those of New York Air and Eastern, between New York and Washington and New York and Boston.

Even though New York and Washington have multiple airports, we concluded that shuttle markets are airport-specific. Furthermore, two of the shuttle market airports, LaGuardia and Washington National, are slot-constrained.

Therefore, we disapproved this transaction. Texas Air arranged to sell New York Air's shuttle service to Pan American. Texas Air and Eastern then resubmitted their merger application and it was approved.

In the USAir-Piedmont proceeding, no—I repeat, no—significant opposition appeared. One western carrier did attempt to use that case to call attention to its desire to provide service to two of the slot-constrained airports on the East Coast. But its objections had very little to do with the substantive issues of the case.

Thus, of the 21 merger proposals that you see on the chart that we have reviewed, only two raised serious competitive issues concerning the merging carriers' principal hubs, and those hubs were Minneapolis-St. Paul and Detroit in the Northwest-Republic case and St. Louis for TWA-Ozark.

In the TWA-Ozark case, the only opposition came from the Department of Justice, and that is an important point I think also.

Now, in many industries, especially manufacturing industries, high concentration figures can be reliable indicators of market power. The expense and time needed to duplicate production facilities on an economic scale means that abuse of market power will not necessarily attract new competition within a reasonable time frame. And both we and the Department of Justice use two years as the reasonable time frame for projections.

But the airline business is very different, I think as you all would recognize, from many other businesses. It is inherently dynamic. An entry into a new city-pair market often requires little more than the shuffling of equipment, in other words airplanes, and the leasing of gates at an airport.

As a result, airline markets can function competitively even when they are highly concentrated. An attempt by an established carrier to exercise market power by raising air fares to supra-com-

petitive levels may well prompt new entry by one or more competitors within the two-year time frame that we use.

Now, in the Northwest-Republic and TWA-Ozark mergers, the Department of Justice argued that the hub dominance that Northwest and TWA would obtain made the traditional approach to concentration statistics appropriate to the airline markets affected by the mergers.

We did carefully consider the Department of Justice's analysis and we closely examined the markets affected by these mergers. We agreed then and we agree today that hubbing can produce significant efficiencies.

But after looking at the specific markets at issue, we disagreed that the efficiencies of hubbing were so great that they could be matched only through the creation of a competing hub at the same location. Rather, we found that other factors, such as lower operating costs, strong local traffic demand, reliance on one-stop or connecting service, or feed from their own hubs, would permit carriers to enter these hubs and initiate service in the city-pair markets served by Northwest and TWA.

We also found that gate space at Minneapolis-St. Paul was underutilized at all times of the day, including the 25 percent of gates not controlled by Northwest. Sub-letting of gates is a common practice and airport commissions are generally committed to facilitating entry by transfer of gate leases or the construction of new gates.

While gates at St. Louis' Lambert Field were fully leased, we found that some of the gates leased by carriers other than TWA or Ozark were underutilized and that the sub-leasing of gates was practiced at Lambert by several of the carriers in the market.

In its comments to the Department in the TWA-Ozark merger case, the city of St. Louis also stated that it could build gates to accommodate entrants within a reasonable period of time.

We also noted that 14 carriers had begun service to St. Louis in the preceding five years, with four of them entering that market in the year prior to the merger application.

I think sufficient time has elapsed to make some preliminary evaluations of these two mergers. It would be misleading to say that everything has turned out perfectly. There were, as with mergers in any industry, problems with integrating large companies, companies with different operating practices and corporate cultures.

But if you look at what has happened at St. Louis and Minneapolis-St. Paul and Detroit over the last two years, you will find not only that new entry has occurred at each of these hubs, but competing incumbent carriers continue to provide competitive service.

At St. Louis, Braniff initiated service since the merger with 14 points per week, and that is now up to 27 a week. Between March 1986 and August of this year, Southwest has increased flights from 109 weekly to 161, and United increased weekly frequencies from 50 to 61.

Total weekly seats in the St. Louis market rose from roughly 390,000 in March of 1986 to 432,000 last month, and that is an increase of about eleven percent.

Braniff has also initiated service at Minneapolis-St. Paul and has got 14 flights a week in and out of that facility. Also, between March 1986 and August of this year, American increased its flights at Minneapolis-St. Paul from 55 to 70 a week, Pan Am's weekly departures went up from seven to 28, and United's weekly frequency increased from 71 to 111.

Total seats in that market rose from 286,000 in March two years ago to 322,000 last month, an increase of about 13 percent in just two years.

At Detroit, Continental has increased weekly frequencies from 108 to 131, United has increased in Detroit from 63 a week to 104, and Southwest has gone from zero to 45 a week. Total seats in the Detroit market have increased from 314,000 in March of 1986 to 345,000 last month, an increase of ten percent.

Mr. Chairman, at the request of Senator Danforth, the General Accounting Office did analyze fare and service changes at the Lambert St. Louis International Airport following the merger of TWA and Ozark. And the GAO shared the results of this work with our staff during the normal review and comment process, and I would like to give you our brief evaluation of this analysis.

First, we think that the GAO work is straightforward, if not technically sophisticated. We do not disagree with the GAO numbers. Indeed, for the most part they got the numbers from us.

But we do believe they must be interpreted with some care. For example, the GAO found that TWA now provides non-stop service to more cities than did TWA and Ozark together before the merger, and that TWA offered more direct service with no change of planes to more cities than TWA and Ozark did before the merger.

I am talking specifically about out of St. Louis. Yet, I would be reluctant to infer a causal relationship between those increases in service and the merger. Equally, I believe, one should not draw a causal relationship between the GAO's findings on changes in air fares in the St. Louis markets and the merger.

In the area of fares, the GAO found that TWA's fares, unadjusted for inflation, were up 13 to 18 percent in the first three quarters of last year compared with the same quarters in 1986.

But it is important to note that 1986 was a period of unusually low domestic fares for TWA and for the domestic industry in general. TWA's European traffic was depressed because of the threat of terrorism, and the carrier was attempting to stimulate domestic and international travel through deep fare reductions. Domestic yield, that is revenue per passenger mile, for TWA was down almost ten percent in 1986 alone.

Now, we have performed a similar analysis to that performed by the GAO, using 33 markets served by TWA and Ozark before the merger, and comparing average fares for the fourth quarter of 1985 to the fourth quarter of last year. And over that two-year period, average fares in these markets were up 18.2 percent, or 9.1 percent per year. And that is again unadjusted for inflation.

We also analyzed fare changes at two other hub airports for these same 33 destinations by the dominant carriers at those hubs, as did the GAO. TWA's fare increases were within the range of in-

creases experienced at these other two hubs, neither of which was directly affected by either Northwest or TWA mergers.

For example, average fares over the last two years are up 22 percent, or 11 percent a year, from Dallas-Fort Worth and eight percent, or four percent a year, from Chicago. Thus, average fares charged by TWA for service to and from St. Louis are in the range of what has occurred at the other two hubs being used for comparison.

Now, after adjusting for inflation, average domestic air fares nationally are up approximately eight percent through the first half of this year over the same period a year ago. There are, however, some good reasons why we think that this happened.

First, fuel prices increased throughout 1987, especially compared with the dramatic falloff in fuel prices that began in 1986. You will recall that at the beginning of 1986 average fuel prices were 81 cents a gallon, but by the end of that year they were down almost half, to 43 cents per gallon, and then they went back up during 1987 to 60 cents a gallon.

Well, since fuel costs account for roughly 20 percent of industry operating expenses, it's not surprising that higher fuel costs, after a few months lag time, often result in higher fares.

In the last few months, fuel prices have begun to decline again and are now at about 51 cents per gallon, and we would expect that, also after a few months lag time, to show some effect in slowing fares down again.

Second, many of the aircraft in the nation's commercial fleet are being replaced, and that fleet is expanding. As the chart here on my left illustrates, already this year U.S. airlines have ordered 348 large jet aircraft, representing \$13.9 billion in orders, and that is on top of the 232 aircraft and \$12 billion in orders last year.

The airlines will obviously need to earn the revenues necessary to pay for the almost \$26 billion in aircraft ordered in just the last two years alone.

Third, the safety rules the Department has issued in recent years have added to the industry's costs and will continue to raise the airlines costs of doing business. For example, since 1984 we have adopted new safety regulations that have imposed costs of more than \$450 million on part 121 air carriers.

This figure, by the way, does not include the costs of additional non-regulatory actions or enhanced enforcement by the FAA.

Five of the most costly recent safety-related rulemakings are: fire-resistant seat cushions, which will cost the industry about \$29 million; fire-resistant liners in baggage compartments, another \$23 million; improved flammability standards for cabin interiors, that is going to cost some \$250 million; the installation of improved cockpit voice recorders and flight data recorders, that is another \$27.6 million; and improved protective breathing equipment, that is another \$61.1 million.

In addition, we anticipate substantial additional costs will be imposed on the industry as the result of final rules scheduled to be issued this year, including the one I have just announced today requiring an onboard windshear detection equipment and the TCAS rules, the traffic alert and collision avoidance system requirements.

These costs obviously also have to be recovered, and that may mean somewhat higher air fares.

Fourth, airline traffic has been growing rapidly over the last two years. In fact, between May 1986 and May of this year passenger traffic has grown approximately 18 percent. Strong traffic growth obviously places upward pressure on air fares.

At the same time, it is important to recognize that fare competition remains very strong in many markets. In fact, in the last few weeks Continental, American, Eastern, United, and Pan Am have introduced new discount fares in numerous markets.

For example, in the Boston-Florida market Continental has introduced a \$39 off-peak fare that is effective from September 12 to October 11th. American has introduced discount fares from its Nashville hub, and United is offering new low fares from Houston to Chicago, Washington Dulles to Nashville, and Washington Dulles to Pittsburgh.

So to summarize, Mr. Chairman, overall the airline industry has become much more competitive as to price and service as a result of economic deregulation. Air carriers have reduced their costs, increased labor and equipment productivity, initiated innovative marketing practices. They have entered hundreds of new city-pair markets, created new hub complexes, expanded their marketing affiliations with independent regional carriers, and, as you saw from that chart, they are investing billions of dollars in new aircraft.

Now, these developments have benefited the American consumer, and there is every reason to expect that the American consumer will continue to receive the fare and service benefits of airline economic deregulation in the years ahead.

The airline industry has its flaws, just as every industry does. But it is doing a much better job in an economically deregulated environment than could possibly be the case if it were still straightjacketed by heavy-handed economic regulation.

Mr. Chairman, that concludes my prepared statement. I will be happy to take any questions.

Senator EXON [presiding]. Mr. Secretary, thank you very much.

In evidence of the fact that we have many distinguished and very important witnesses today and a good turnout of the committee, I am going to regulate by rounds the questions to five minutes. I will start out with one basic statement and a question, and then I will yield what remaining time I have to Senator Danforth, whom I will recognize next.

You said in your prepared statement that there was one western airline that raised some objections that probably weren't on point with regard to the last hearing or that last discussion? Was that America West?

Secretary BURNLEY. Yes, it was.

Senator EXON. Can you tell us what you, as Secretary of Transportation, think the answer is to airlines like America West who are seeking to begin direct service to points such as Washington, D.C. and New York City and are prevented from doing so because of the current arrangement?

Secretary BURNLEY. Mr. Chairman, I will invoke the observations of Senator Kassebaum in part, and that is that obviously the underlying question is capacity. I think there are a couple of ways to

get at it, and I'll treat the instance of America West's strong interest in coming into the airports in New York and Washington first.

We do have capacity at BWI. We have capacity at Dulles, and we have capacity at Newark. And it is not the case that America West is locked out of those metropolitan areas. To the contrary. They could make arrangements beginning today, if they wished to, to serve any of those airports. The facilities can accommodate additional traffic today. So, I think it is terribly important to recognize that point. And as you know, we have seen extraordinary growth at BWI and Dulles in the last few years because other airlines have recognized that those are opportunities in the Washington area.

Senator EXON. Mr. Secretary, that is a good excuse, and maybe that is something that America West and others should pursue. But that isn't where the people want to go by and large. And, of course, that is back honing in on the point that many of us have concerns about of the monopoly that seems to be created by some of the major carriers.

Put back up the chart, if you will, that had the number of new airlines ordered, which I thought was quite impressive. Do you happen to have with you or could you tell us what percentage of those new aircraft orders are from other than the dominant carriers?

Secretary BURNLEY. We can provide that to you, Mr. Chairman.

Senator EXON. I would appreciate you providing that for the record.

[The following information was subsequently received for the record:]

Based on information provided to the Department by the Boeing Corporation, from January 1987 through August 1988, U.S. airlines placed orders (not options or letters of intent to purchase aircraft) for 580 large jet aircraft valued at almost \$26 billion. As shown in the following table, the major airlines accounted for 52.2 percent of the total, other airlines accounted for 15.4 percent, and leasing companies accounted for 32.4 percent. Although it is not possible to determine which airlines will ultimately lease the aircraft ordered by the leasing companies, it is reasonable to assume that many of these aircraft will be leased by U.S. airlines. Indeed, almost 50 percent of the jet aircraft operated by U.S. airlines today is leased, not owned.

NEW AIRCRAFT ORDERS FOR U.S. AIRLINES, JANUARY 1987 THROUGH AUGUST 1988

	Firm orders	Percent of total
Major airlines:		
American.....	140	24.1
Delta.....	42 ¹	7.2
Northwest.....	23 ²	4.0
Texas Air Corporation.....	7	1.2
Trans World.....	(³)	
United.....	41	7.1
USAir.....	50	8.6
Total.....	303	52.2
Other airlines:		
America West.....	14	2.4
Federal Express.....	5	.9
Midway Airlines.....	11	1.9
Presidential Airways.....	10	1.7
Southwest.....	43	7.4
Westair Airlines.....	6	1.1

NEW AIRCRAFT ORDERS FOR U.S. AIRLINES, JANUARY 1987 THROUGH AUGUST 1988—Continued

	Firm orders	Percent of total
Total.....	89	15.4
Leasing companies:		
GATX Leasing.....	10	1.7
International Lease Finance Corp.....	174	30.0
Pola Leasing.....	4	.7
Total.....	188	32.4
Total orders.....	580	100.0

Source: The Boeing Corporation.

¹ Does not include Delta's recently announced order (September 23, 1988) for 215 aircraft (18 firm orders and 197 options) valued at more than \$10 billion.

² Does not include the October 2, 1986, agreement by Northwest to purchase 100 A-320 aircraft, valued at more than \$3 billion.

³ In its recent 10-Q report to the Securities and Exchange Commission, TWA states that it is engaged in discussions with several aircraft and engine manufacturers that could potentially provide TWA with up to 60 new aircraft over a three- to five-year period. The aggregate cost of the 60 aircraft is estimated to range from \$1.5 to \$2 billion.

Secretary BURNLEY. The bigger carriers are ordering more planes than the smaller carriers.

Senator EXON. I think that is a point that shouldn't be overlooked.

I reserve the balance of my time and yield it to the Senator from Missouri, Senator Danforth.

Secretary BURNLEY. If I could, Mr. Chairman, I wanted to finish answering your question.

Senator EXON. Excuse me. I thought you had.

Secretary BURNLEY. That's okay. I had given half an answer.

Let me just note parenthetically, by the way, in terms of where people want to go. The fastest growing airport in America in the last three years is Dulles by several country miles.

Senator EXON. And why is that? Because they can't get into National. Right?

Secretary BURNLEY. No, sir. I think it is in large part because there is enormous economic development going on in northern Virginia and, in fact, there is a tremendous amount of new traffic in and out of northern Virginia, so that I think that airport which, as we all know, was grossly under-utilized for almost three decades has now come into its own because of the surrounding area.

But let me come to the other part of the answer quickly. We are right now at the Department exploring the real problems that exist at the slot-constrained airports. We have been wrestling with this issue for many years, as you know. There is no perfect answer to it, but we have I think a pretty good story to tell in terms of the answer we have got in place right now, buy-sell being a better answer on balance than the other alternatives that we have looked at, including the committee approach that we used that broke down a couple of years ago.

But we are looking right now at whether it might be possible to move some slots from one category to another—not from airline to airline, but from category of carrier to another category so that a carrier like America West has the opportunity to come into this marketplace if it wishes to do so. That is still tricky business, and I am not making any commitment that it will work.

But we are exploring some alternatives of that sort, and Senator McCain has been very interested in this issue and has been pressing us hard to make sure we were focused on that as an alternative. So, it might well be possible even at the constrained airports to figure out a way to accommodate this interest.

Senator EXON. There have been some other Senators, including this one, in addition to Senator McCain. I appreciate your mentioning his name. There have been some others that don't happen to have America West in our states.

Secretary BURNLEY. I stand corrected, yes, sir.

Senator EXON. But America West provides great service to the people in our state as well.

Secretary BURNLEY. Thank you for correcting me.

Senator EXON. I am trying to reserve some time for you, Senator Danforth. I yield to you.

Senator DANFORTH. I also notice, Mr. Chairman, that there is a roll call vote on the floor of the Senate. So, maybe Senators want to go and vote early and come back. Would it be all right to maintain the constant flow of questioning?

Senator EXON. Let's try to do that.

Senator DANFORTH. Mr. Secretary, thank you very much for your testimony. Let me just make sure that we are on the same philosophical wavelength.

You do believe, don't you, that there has to be some substitute when deregulation takes place and that competition is the alternative to regulation?

Secretary BURNLEY. Absolutely.

Senator DANFORTH. And therefore deregulation should not mean and cannot mean that airlines can create monopoly situations and therefore do anything they darned well please. There has to be some market for us that bridles them if the regulators don't.

Secretary BURNLEY. Not only do I believe that, but I went through this detailed discussion of how we have looked at mergers in 21 cases because we have been, in fact, very aggressive and vigorous in looking at competitive issues, where they existed.

There are those who make broad, sweeping statements—here were some in the Washington Post Sunday. You will probably hear some more today—saying that we have totally abdicated anti-trust enforcement. That is completely untrue, and I went through the factual records so that I could document in detail how in error that view is.

Senator DANFORTH. With respect to Lambert, 82 percent of the passengers who are going through Lambert are on TWA flights. The number of routes served by two or more carriers decreased in one year from 64 to 36. The fares have gone up twice, three times the national average. Now, there may be justifications for this.

Let me ask you this. Have you just totally made up your mind that everything is hunky-dory at Lambert, or has at least a reasonable basis for doubt been placed in your mind by the GAO report?

Secretary BURNLEY. Senator Danforth, I think the GAO report does highlight a legitimate concern and problem at Lambert. When we looked at the proposed merger, what we found was that if Southwest Airlines wished to do so—and that is all laid out in the

merger decision—the capacity we believe was at Lambert or could very rapidly be created—

Senator DANFORTH. I want to get to that later because I do have other questions for you. The question I am asking now is just a matter of really a general conclusion. Have you just made up your mind that everything is just terrific at Lambert?

Secretary BURNLEY. No.

Senator DANFORTH. Or do you have at least some basis for perhaps more investigation and analysis of what is going on?

Secretary BURNLEY. What I was trying to say was that the way we thought it would work has not, in fact, occurred as the GAO report shows. We thought Southwest could handle 60 flights a day in and out of that airport and provide the competition necessary with the merged carrier. In fact, they are averaging 22, 23 flights a day today out of Lambert.

And I would like to know more about why that has occurred, and I would like to know more about what constraints, if any, exist on new gates, that kind of problem. And I have, in fact, because of your triggering this GAO study and what the GAO study found, instructed my staff to pick up where GAO ends. And we will this fall do a further analysis of what is going on at Lambert because I think it is terribly important to understand.

Senator DANFORTH. I appreciate that. The Department of Transportation will conduct further investigation of what is going on at Lambert. My hope is that you would do it with an open mind, that you wouldn't say, all right, let's conduct what we call a study which simply debunks the GAO and says that, oh, everything is just great at Lambert. Let's take an objective look at the situation at Lambert to see if there is a real problem.

Secretary BURNLEY. Senator, if anybody that works for me even had that notion, I hope I have foreclosed that approach this morning by saying that the GAO study, while not going as far as it might, is straightforward and they used our data. So, that will make it I hope impossible for anybody at the Department of Transportation to simply try to debunk it. I think it is a sound piece of work that is also a very incomplete piece of work. And that is why I would like to go beyond it.

Senator DANFORTH. Mr. Chairman, I do have other questions, but I think we are running out of time on the floor.

Senator EXON. I think it would be best if we take approximately a five minute recess and then we will return.

[Recess]

Senator EXON. The committee will please come to order. And I would ask the timekeeper to advise the Chair. Had Senator Danforth completed his round or did he have some time remaining on his time plus the time that I yielded to him? I believe that Senator Danforth has more time. So, I will recognize Senator Danforth again.

Senator DANFORTH. Mr. Secretary, again I was asking you as we left to vote about the plans of the Department of Transportation with respect to Lambert and whether you would pursue the lead, so to speak, that the GAO had given you. And your answer again was—

Secretary BURNLEY. My answer simply, Senator, is that as a result of your pressing us on this point and getting the GAO study done, I am going to send people to St. Louis, and we are going to take a very close look at what is happening in that marketplace to be sure we fully understand it.

Senator DANFORTH. Thank you very much.

Now, if we are to move toward more competition, if that proves to be necessary, one suggestion that some people have come up with is that we need more gates. We have to have more gates to serve more airplanes.

Let me ask you, first of all, with respect to the aviation trust fund, it now has about \$6 billion in it. What plans do you have with respect to spending that money, and what is your response to the suggestion that has been made by the Airport Operators Council with respect to the creation of a revolving loan fund to finance airport expansion?

Secretary BURNLEY. Senator Danforth, as I think you have recognized, we want to spend every dime that is in the aviation trust fund, but the tug of war that continues between the authorizing committees and the appropriations committees means we continue to take funds that ought to come out of the trust fund, out of general revenues instead to meet aviation needs.

So, I hope, since Congress has now built a trap for itself when it comes back—where, unless it takes action, aviation fuel taxes and ticket taxes will drop by half on January 1, 1990. That is precisely I think the wrong way for us to go given these needs. We ought to continue that revenue stream at present levels it seems to me.

I hope Congress will address this issue and that this tug of war of several years can be resolved in a way that permits us to go ahead and spend the funds for aviation needs out of the trust fund. That's the way it ought to be done.

Some of the ideas that have been discussed recently, such as revolving loan funds, seem to me intriguing. There are other ideas using sale and leaseback techniques by the local authorities that could also generate some revenues. We have had discussions in the past—I think it is worth looking at again—at the idea of permitting airport operators to charge passenger facility charges and to generate some revenues that way.

So, I would urge the Congress in the next session to look again at that whole panoply of ways to make it possible for airports to increase their capacity.

I must point out, however, that at our major hubs in this day and age, the primary capacity constraint that we see over and over again is not money. Money is an issue. You have to think about it, and you have to work on figuring out ways to raise the necessary funds. But we continue on an increasingly frequent basis to see the primary capacity constraint related to environmental concerns, noise concerns, and the tension that you have in the neighborhoods immediately surrounding an airport or under the flight paths, which lead to local opposition to expansion.

A very disturbing pattern is emerging in the airline industry, it seems to me, who have argued vigorously for several years, and particularly this year, and urged the Congress and urged the ad-

ministration to do everything possible to increase the national system's capacity.

And on the other hand, in Denver, in the Chicago metropolitan area, when the local government units and officials get moving on building new hub airports and looking at that idea seriously, what happens to them? The first source of opposition are the major airlines who are already providing service into those communities. And I think that is irresponsible. It is hypocritical. And I think that both the administration and the Congress ought to call them to task for that. That kind of a very shortsighted attitude on the industry's part cannot be justifiable.

And when you see particularly—not just the individual carrier, but when you see the Air Transport Association itself voting against, as it did just last month, serious consideration of a new hub airport in the Chicago area, then it seems to me that the industry has some explaining to do about whether it really does want to take the steps necessary to increase capacity.

Senator DANFORTH. Mr. Chairman, the red light is on. If no other Senators are here, I do have other questions.

Senator EXON. I will recognize you again in a minute, but I have some further questions, Senator Danforth. And then I will be glad to proceed on the line of questioning that you are addressing.

Mr. Secretary, let's go back to a question that I asked first, you know, the long-term overview. We have a lot of problems. And I believe that the basic concept of deregulation, that the free enterprise system is going to be expanded and is going to allow a lot of entry of new carriers that are going to provide competition. To some extent that has happened.

I would simply point out that in 1978, according to my records, the major carriers controlled about 81 percent of the traffic at that time, and after deregulation, sure enough, it happened. The major carriers' portion of the traffic dropped to approximately 76 percent in 1984. But, by 1987, I notice with keen interest that trend has been significantly reversed. And it is headed back up to where the major carriers now are in control of about 92 percent of the nationwide market.

I would simply suggest that from that standpoint, while I think overall deregulation has been good, deregulation has not necessarily provided increased competition. And I suspect that we are likely to see a shrinkage of even the eight carriers that now make up the so-called major carriers' share of the marketplace.

Also I notice in specific terms that airports such as Atlanta where Delta and Eastern have 93 percent of the traffic; Charlotte, Piedmont with 81 percent; Chicago, United and American with 72 percent; Dallas/Ft. Worth, American and Delta, 85 percent; Denver, United and Continental, 86 percent; Detroit, Northwest, 68 percent; the same airline, Memphis, 74 percent; same airline, Minneapolis, 79 percent; Pittsburgh, USAir, 82 percent; St. Louis, TWA, 82 percent; and Salt Lake City, Delta with 76 percent—now, given that picture and given the fact that America West and some of the other carriers just cannot get into some of these places where most people want to go, are you concerned, as Secretary of Transportation, about what I see and fear is going to be a control of the major markets of the United States by a relatively few air-

lines which with many of the gimmicks—and I am not criticizing the airlines for this because if I were in the airline business, I would be doing the same thing that they are doing. The frequent flyer type programs enhances my position.

We do have antitrust laws that are in place on this. Do you, as Secretary of Transportation, or have you had any conversations whatsoever with the Justice Department as to whether or not there is concern in either the Department of Transportation or the Justice Department today with regard to the antitrust laws that are now in place being used if this concentration of major traffic to major hubs continues?

Secretary BURNLEY. Mr. Chairman, you accurately state what has happened in the 10 year period in terms of the new entrants into the airline business and the consolidation.

Yes, we are concerned about watching those dynamics as the concentration has returned and making sure that we understand it fully. And I don't think that that is necessarily true, which is one reason why we are going to go take a further look at St. Louis and be sure we fully understand what has happened there.

But let me make the following point, if I could. And I think it is a terribly important distinction. To say that there are fewer airlines is not—is not—to answer the question is there more or less competition.

Let me put it another way. If you have one very strong, dominant carrier and a lot of little weak carriers, you can have a much less competitive situation than if you have 8 or 9 or 10 or 15 strong carriers all vigorously competing with each other. Now, the figures you gave on dominance of hubs also are accurate.

That kind of hubbing was not created by economic deregulation in 1978. It is important I think to remind everyone of that. It existed before that. It has certainly become a much more visible and dominant phenomenon in the industry. Hub and spoke is now the way they all do business, and before 1978 that was not the pervasive technique. But it was known and we had hubs.

If you ask the people at Raleigh-Durham, if you ask the people of Indianapolis, the people of Charlotte, the people of any of these cities that have developed new hubs in the 10 years since deregulation whether they have benefited from that or not, I think you will find an overwhelming reception that the communities have benefited enormously. They have service far beyond their wildest expectations.

And I know that. I'm a North Carolinian, as you know, and I am very conversant with the unbelievably intense competition that went on among medium sized cities in the southeast to get Piedmont to hub, to get American to hub when word got out that these airlines were looking for new hubs.

So, while those numbers are absolutely correct, on the one hand, on the other hand, the communities that are getting the service that they never had any expectation would be available to them think that is good, not bad.

And we do still see, even at those airports, the discipline of competition working. It does still make a difference in what tickets cost. If that were untrue—and we can go through it market by market if you wish. I have some of that data with me today—but if

that were untrue, then there would be no way that we could have seen a 13 percent plus decline in average air fares when you keep them in constant dollars over the last decade. And that is what has happened in this country. Average fares have gone down in constant dollars in the last 10 years.

So, clearly, to come back around, we have to keep an eye on it. When you see consolidation, you have to be vigilant. You do need to understand what this means. You have to make sure competition is continuing.

But it is terribly important to recognize the difference between the fact that you have big airlines who may provide a lot of service and the question of whether or not there is competition—because you can both have big airlines providing most of the service, and extremely vigorous competition, which is what we also have overall.

Senator EXON. My time is up. I will recognize Senator Kassebaum who is next on the list.

I would just say that when we talk about average fares, the average fares have not gone down between Omaha, Nebraska and Scotts Bluff, Nebraska and all points in between. I just make that point. And so, when we talk about average, we are forgetting about those many sections of our country, of which Omaha and Scotts Bluff are very typical, that have not fared at all well under the so-called competition.

I would only remind you, Mr. Secretary, that once again I was focusing on the fact not what it is today, what is it going to be in the future.

Senator Kassebaum.

Senator KASSEBAUM. Mr. Chairman, I would just like to ask Secretary Burnley if you know of any instance where an airline that has become dominant in a hub has ever been dislodged by any competitors who try to seek entry.

Secretary BURNLEY. I know of countless instances, Senator Kassebaum, where new competition has come in. And I, in fact, outlined several of those in my testimony today.

Senator KASSEBAUM. Well, you did——

Secretary BURNLEY. But dislodge would imply I think, if I understand your question, that they ended up greatly reducing their share of service or——

Senator KASSEBAUM. And that is perhaps too strong a word. No, I think you gave some very effective examples.

On the other hand, most of that has been accomplished by fare wars. And that to me is a very destabilizing part of the system. Either the fares were not accurate in the first place or else you find a situation, such as you gave as an example with People Express, that in order to just keep afloat airlines have gambled by offering very cheap fares. I worry that that causes distortions not only in fares, but in a destabilizing effect at that hub.

Secretary BURNLEY. Well, Senator Kassebaum, there is no question that you are correct that the fare wars of the mid-1980s—and I am talking about the big ones, the national ones, the ones People Express to a very large extent generated when it was in business—certainly caused very rapid changes in the marketplace. But on the other hand, tens of millions of Americans who could not otherwise

afford to fly in and out of hubs were able to fly because of those fares. And we all remember the pictures of the kids with their knapsacks who were camped out waiting to get on People Express flights a lot of the time, people carrying their baggage on and off. That, to put it mildly, was not a service-intensive carrier. So, all I am saying is there were in that period a lot of changes, even chaos, perhaps enormous economic benefits for the American flying public.

Now, it seems to me that, again, we have to be vigilant and be sure we understand what is happening here. But I hope that we can all be cautious in drawing conclusions at least until we understand what is happening.

And, two, I think the comparative question here for us all is not "Is it perfect?" or "How far from perfection is the airline industry today?" As I said in my testimony, and I will say it as many chances as you give me, it ain't perfect. But, on the other hand, the comparison should be "Is it a whole lot better than it would be if we were fooling around with economic regulation again?" And I think by any measure it is clearly a much, much healthier situation.

You touched upon a very important point. The airline industry today is an industry that does not show great economic health. It is not one of those industries that you would point to as generating monopoly profits. To the contrary. The industry today by a lot of measures is not as profitable as it was in 1978. And we have individual carriers like Texas Air's operation, for example, and the carriers it owns that are showing extreme difficulties. Pan Am was another example we all know about.

Some of the carriers that are relatively prosperous are still only relatively prosperous, like a TWA who will be testifying before you later, who have made substantial progress in the last two years economically, but who are still far from being a financially sound, healthy carrier, I would think they would be the first to say.

Senator KASSEBAUM. Thank you.

Senator EXON. Senator McCain.

Senator MCCAIN. Thank you, Mr. Chairman.

Thank you for your testimony again, Mr. Secretary. It is excellent. I think you make a strong case for what basically has been the philosophy of this administration and, indeed, the previous administration toward the airline industry.

To correct any misimpression that might have been created, indeed, I am concerned about the ability of America West airline to achieve a competitive status. It happens to be based in my state.

But I am far more concerned, Mr. Secretary, as you know, that a combination of events could lead us to a situation of de facto regulation. I believe a case could be made that in those airports that are slot-limited today that we are de facto regulated because they are in some cases dominated by one or perhaps even two airlines, and nobody else can compete. I understand that you are soon perhaps going to come up with some recommendations that will provide some form of relief, or more accurately, a form of increased competition.

We all know the long-term answer clearly is to build more airports. I think we can do that in the west. I think they are doing it

in Colorado. I think we would like to see us do it in Arizona. I don't think we are going to build more airports in California or in most parts of the east coast simply because there are no places to build them. Do you agree with that?

Secretary BURNLEY. I do agree with that. That is less likely to happen at least than to see them build in some other areas.

Senator McCAIN. So, then I think we have to look at other ways to prevent total domination of one hub or one market area.

You know, I continue to be fascinated by a couple of the major airlines, one of the major ones in particular whose Chairman testified before this committee. He said we will just put them all open for bid and failed to mention that he got those slots for free, which is really not a bad deal when you think about it. What's his is his and what's anybody else's has to be paid for at clearly premium prices. So, I don't think that is the answer either.

I will look forward to seeing the recommendations that you and your very capable deputy come up with very soon.

Have you had an opportunity—I know you are very busy—to read the testimony that Mr. Kahn will present before the committee?

Secretary BURNLEY. I have not gone through it in detail. I asked someone on my staff to look at it.

Senator McCAIN. I hope you have an opportunity because he has some very I think important recommendations and statements to make. Frankly, I don't know of a more credible person on this issue in America.

One of the issues that he addresses in his testimony, which has been a matter of concern to you and this committee, is the CRS situation. Mr. Kahn states that possibly we should consider a prohibition—and I hope I am not misinterpreting his statement—on ownership of CRSs by airlines. Do you think that is too draconian a step?

Secretary BURNLEY. I do think that the data that we have available—and as you know, Senator McCain, we had a very extensive study and presented it to the Congress at the Congress' request this spring on this whole issue. The data that we have to date falls far short of justifying either a regulation or a statute that forbids the airlines to own CRSs systems.

I also think, on the other hand, that we have to be sure that the anti-discrimination regulations that we did put out in 1985 are being rigorously adhered to by the CRS vendors and that you have to be careful not to draw superficial conclusions from the fact that big airlines own CRS systems. You have to look at what is happening there.

For example, in the last couple of years, as our study shows, 10 percent of the travel agents in this country have changed systems. Now, that means there is something going on there. There is movement in the marketplace.

And what we did not satisfy even ourselves on, in that study, was that we had a perfect understanding, after looking at it at great length and in great detail, of what the marketplace relationship is between owning a CRS system and owning an airline. So, it is not that Dr. Kahn's view is one that I find illegitimate. All I am saying

is I think we were far short of reaching the point where you can draw conclusions of that sort.

Let me just say you have been, as Senator Kasten has been, as Senator Exon has certainly been, interested not just in individual carriers getting into individual airports in the east coast, but in this underlying issue. In fact, I look around the room and every single member of this committee has been in touch with me repeatedly on that subject. It is a very important subject, and it is not one to which—again, I wish I had perfect answers to everything, but that is one where I don't think anybody has got a better answer than the system we have today, but there are legitimate reasons to be dissatisfied with that system.

Senator McCAIN. Let me ask whether there is any doubt in your mind that abuses are taking place as we speak and that certain airlines, because of their ownership of CRS's, are indeed obtaining an unfair advantage over other airlines?

Secretary BURNLEY. Since 1985 when we put out a regulation that said they could not discriminate on the CRS systems among carriers, I do not know—and I don't know of any one who claims with factual data to back up the claim—of any sort of pervasive or systematic abuse. If such information is made available to us, we are going to take that very seriously because we have regulations on the books that say you can't do that, you cannot discriminate.

Now, one of the things that is going on out there in the state courts of this country, which is where I think this particular issue belongs, is that you have owners of these systems suing each other about contractual terms or backing lawsuits by travel agents who want to change vendors. And that kind of contractual dispute has been going on now for two or three years, and it has been going on with everybody accusing everybody else. But I think that is a very different dynamic from the question of whether somebody who owns a CRS system is systematically "sticking it" to its competitors. And I would be extremely interested in any information that indicated that was happening.

Senator McCAIN. On the issue of compensation of travel agents, today—

Senator EXON. Senator McCain, I would just remind you that you are over your time.

Senator McCAIN. I'm sorry, Mr. Chairman.

Senator EXON. Please go ahead and ask your question.

Senator McCAIN. Mr. Chairman, I am sitting down here in the boondocks. I don't have availability of a view of the monitoring.

Senator EXON. The other problem in the boondocks, you can't get to and from his place of business by air.

Senator McCAIN. Perhaps we should set up a hub down here at the end.

Thank you very much, Mr. Chairman. I apologize. I did not see the lights. Thank you, Mr. Chairman.

Senator EXON. Senator Kasten?

Senator KASTEN. Mr. Chairman, I don't want to repeat everything that you and the Senator from Arizona have said, but I want to make the point that the ability of new entrants and of limited incumbents to obtain slots at the major hubs like Washington, New

York, LaGuardia, is of particular concern, and the problems of slot allocation are continuing to grow.

A lot of these airlines, and some of the ones that we are interested in, have developed a quality of service, frankly, that is better than that of the slot-holders, not just in terms of the routes they serve but also in terms of the way they treat their passengers. One of the points that isn't covered in all of the different data that is being presented here is the quality of service. I think at another time this committee is going to start to pay more attention to the quality of service, bags lost, the quality of service, planes late, planes cancelled, the notice given to people, and so forth. The same is true for the complaints we are getting now in terms of people being put on a plane early, when the airline knows that the plane isn't going to take off, so that the passengers don't get on the competing plane out of O'Hare, for example. We hear, for example, that an airline knows that there is a mechanical problem, but they get everybody on the plane anyway so passengers can't make it across the concourse to the competing airline.

Cancelled flights is another problem. Numerous complaints are coming in to me now from Minneapolis particularly. I went through one personally in Milwaukee in which it seemed that the airline was cancelling the plane because they only have 4, 5, 10, whatever passengers. Now, the airlines claim that that is not the case, that they have to get their equipment to the other point anyway. But the evidence at least in certain areas is overwhelming.

So, I hope that in addition to all the statistics, that we pay a little bit of attention to the quality of service.

I am hopeful that you and others can start to look at that 60 percent utilization requirement for keeping a slot and watch the schedules change as the time period starts to run out and all of a sudden they have put in a different kind of a schedule so that the utilization will go up to get them over that threshold. I hope that you and others will start to pay attention to linking, that is, where the major airline lets the Air Wisconsin flight use the slot. In terms of utilization of slots, some airlines frankly are bumping up against the spirit, if not the letter, of your rules.

A number of us are interested in changes, and I just hope that you can work with us.

Secretary BURNLEY. I want to comment, if I might, first on the service issue. Again, the airline industry is not perfect, and I have already said things about them this morning that they will scream at me about after this hearing. So, I am not here to defend them.

But the truth of the matter is that compared to a year ago, complaints this summer were down two-thirds. And while service I think still leaves a good deal to be desired in a number of areas, nonetheless, we turned it around. And we turned it around because of the interest of the Congress in this issue and the steps that we took beginning in early 1987—the scheduling meetings that occurred to get rid of this business at hubs of scheduling 20, 30 flights all to take off at 8:00 when everybody knew it couldn't happen, and also the scheduling investigations that were run under Secretary Dole a year ago to make sure that the airlines were simply being honest with their passengers.

And I don't doubt that you are absolutely correct that any time the Federal Government writes a rule, a lot of bright, creative people immediately start figuring out ways to bump up against it, as you say.

I think that we have to keep just that in mind when ideas are bandied about—as in this airline consumer bill that came out of the House a year ago that is still in my judgment properly tied up in conference, which would propose that we extend just the kind of slot constraints that we have now at only four airports in this country to the biggest 40 to 45 airports in this country. Before anybody takes that idea seriously, I hope you will slow them down to talk to them about your concerns about the four and how that system does or does not work.

I mean, to put it another way, every time the Federal Government writes a rule, the best and brightest minds in this country go to work figuring out how to get around it. And the best way I know for us to inhibit and perhaps fatally wound the competition in the airline business in this country is for us to try to figure out how we are going to constrain and regulate who flies in and out of the 45 biggest airports in this country. It is a truly stupendously bad idea in my judgment.

On the other hand, if there is data out there, again I welcome it because we have not been oblivious to this idea of economic cancellations you mentioned. We have looked at that very carefully. We have interviewed people. We have had people out around the country on it. And what we find is that the primary evidence indicates the airlines don't always do a very good job of explaining to their passengers about what is happening.

For example when there is a plane that has four or five people on it, and there is another plane sitting three gates down that has 120 people on it, and that plane develops a mechanical problem, the airline, if it doesn't have a backup plane immediately available, and if it is a well-run airline, will cancel the flight with the 4 to 5 people on it and put that plane at the service of the 120 people three or four gates down. That is the only rational way to handle a problem like that. And yet, if they don't explain it to the four or five very unhappy people that just had to get off, those people think there was an economic cancellation simply because there were only four or five of them on the plane.

What we have also found is the notion, as you suggest, that they have to get the plane somewhere else. That is real. That is not an excuse.

As Senator Exon and I were discussing earlier, hub and spoke has become the dominant pattern in this industry, and if you don't fly your planes where they are scheduled to be next, your hub breaks down, and it breaks down very, very quickly. So, as a matter of just staying in business, they have to move those planes according to schedule.

But again, I don't doubt that there are people out there, as I speak, fooling around with the rules, and we always are interested in whatever information and data we can get because we do take that seriously. And we have, in fact, fined carriers on service issues, as you know, in the last year on several occasions very substantial sums.

Senator KASTEN. Thank you, Senator. Thank you, Mr. Secretary.

Senator EXON. We are in a second round now. I have had my second round. I would ask everyone to move along as quickly as possible, but I'm not going to cut anybody off because this is a very important hearing.

Senator Danforth.

Senator DANFORTH. I am just going to ask one general question and other Senators have touched on it. In the GAO study at Lambert, one of the conclusions is that other airlines that attempt large scale entry or expansion at Lambert will find it difficult to compete with TWA for a significant share of the St. Louis market. This report states that right now TWA has three-quarters of the 75 gates and nobody else has more than 3 gates. And GAO points to a number of reasons for its conclusion that large scale entry will be very difficult for other airlines.

One reason is the fact that long-term leases for exclusive use of the gates have been locked up contractually.

Another is the airline ownership of computerized reservation systems, which has already been brought up by Senator McCain and others.

Another is frequent flyer programs. Even if passengers do have a choice, if one airline has most of the flights going in and out, that dominance is going to perpetuate itself if people favor that airline in order to take advantage of frequent flyer points.

And then apparently there is some sort of an arrangement between TWA and the City of St. Louis which gives TWA a veto power or close to it for new entrants.

I am not raising this now solely from the standpoint of Lambert, although clearly that is my interest, but it would seem to me that all of us, the Department of Transportation and this committee, should really take a look at these practical barriers to entry on a national basis. I mean, it is one thing to say, well, theoretically anybody can come in. But if as a practical matter nobody is going to come in or if there are contractual relationships that prohibit airlines from coming in, then that really I think would be a major problem.

So, my question, Mr. Secretary, is this. Is there or should there be an in-depth analysis of the reality of competition, and should there be some consistent approach maybe through enforcement of section 2 of the Sherman Act which gets at these practical barriers to entry?

Secretary BURNLEY. Senator Danforth, I should probably have my tongue cut out for this, but I cannot help but say we urged the Congress in 1984, we urged the Congress in 1987 to give the assignment of reviewing these issues to the United States Department of Justice where I believed then and I emphatically believe now it belongs. And I am quite pleased that the job is going January 1 to the Department of Justice. And Section 408 as a separate standard with separate burdens of proof self-destructs on January 1 so that the airline industry will be reviewed by the United States Department of Justice Antitrust Division on the same basis as it reviews other industries. For better or worse, that is what is going to happen. And I think it is better.

Now, I don't suggest, on the other hand, that the Department of Transportation will thereafter have no responsibilities in this area. Not only do we need to explain what we did, but I do want to continue the Department's aggressive efforts to understand what we did, and that is why I am sending people to St. Louis to look into the problem that you have highlighted so well.

But it is the practical side of it you allude to that I want to know more about. I think before we make national policy on an issue like this, we do have to understand out in the real world what is happening as a practical matter. And when, on the one hand, two years ago all the evidence seemed to be, including the evidence given to us by the City of St. Louis and by the Airport Commission, that Southwest and other carriers could easily set up very substantial additional service and the gates would be available—if that has not happened, I want to know why. I think it is an important question, and we ought to get those answers so that you and we have a better understanding.

And if, on the other hand, it is about to happen, I want to know that. Maybe it is. I hear rumors that is about to happen in terms of gates for Southwest, but I don't know the truth of that. That is why I want to send people out there to nail these things down.

Senator DANFORTH. Thank you very much.

Senator EXON. Thank you, Senator.

Senator Ford, we will recognize you in a moment. Are there second-round questions by the other Senators that have been here?

Senator FORD. I don't need to be recognized, Mr. Chairman. I think the questions that I wanted to be asked have already been asked.

Senator EXON. Thank you.

Senator KASSEBAUM. I would like to briefly follow up with something that Senator Danforth raised and you responded to, Secretary Burnley.

I am pleased that antitrust jurisdiction will soon transfer to the Department of Justice. However, prior to that transfer the Department of Justice reviewed and made recommendations in every airline merger case before the Department of Transportation. Is that not correct?

Secretary BURNLEY. Senator Kassebaum, they did and in only 2 of the 21 mergers did we disagree with their recommendations.

Senator KASSEBAUM. And one of them, was it not, was TWA-Ozark?

Secretary BURNLEY. That's right. And the other one was Northwest-Republic.

And, on the other hand, I must say that we took this responsibility, and we still do, very seriously. And when you assigned it to us, you did not tell us to slavishly follow the recommendation of the United States Department of Justice. In fact, I think had you wished for us to do that, you would have sent it there in the first place. So, we took their views very seriously, but we, in 2 instances of 21, came to a different conclusion.

So, I think it is important to continue to make sure that the perception of what we have and haven't been doing has some relationship to what happened, and this is what happened over here on the chart. And the Department of Justice in two instances recommend-

ed steps where we have, in fact, done exactly what they suggested among the very small number at the bottom of the chart of mergers where there were genuinely competitive issues.

And again, one of those was opening up a new proceeding on a western gateway as a part of approving the United-Pan Am transfer of the Pan Am Pacific Division, and the other was turning down Texas Air-Eastern because the shuttle issue had not been resolved. And when that issue was resolved by selling New York Air's service to Pan Am, then they reapplied. And we took another look and the Justice Department said that it was satisfied that it had addressed the competitive issues.

Senator EXON. Senator McCain?

Senator McCAIN. I just have one further question, Mr. Chairman.

Mr. Secretary, we all eagerly anticipate the entry of tilt rotor aircraft into the airline industry, and obviously it would have significant impact in a variety of ways, which we don't have to review here.

In what year would we reasonably expect an operational tilt rotor aircraft in the airline industry?

Secretary BURNLEY. It is my understanding, Senator McCain, even with the accelerated interest of the FAA and the industry in this technology is that it will be at best the early, perhaps mid-1990s before it is widely available for commercial service.

And one of the issues that will need to be explored there is cost. I don't think we yet know the answer, and it's one of the areas where the FAA and the industry are working together as to how much the service is going to cost when you use this kind of technology. We are cautiously optimistic that it will be economically feasible, but—

Senator McCAIN. Cost in terms of the price of the aircraft or the cost per mile?

Secretary BURNLEY. Also the operating cost of the aircraft. Both are issues about which there are many more questions than answers. But it's a technology that does give us some reason to hope that particularly in short hops we'll be able to provide some additional ways to get in and out of major metropolitan areas without having to greatly expand existing airports or build lots of new large hubs.

Senator McCAIN. Thank you, Mr. Chairman.

Senator EXON. Thank you.

Senator Kasten, do you have any further questions?

Senator KASTEN. No, thank you.

Senator EXON. If not, Mr. Secretary, we thank you very much for your patience, your long stay here, nearly two hours, and we appreciate your forthright answers to our questions. You are excused.

[The following information was subsequently received for the record:]



THE SECRETARY OF TRANSPORTATION

WASHINGTON, D.C. 20590

January 19, 1989

The Honorable Ernest F. Hollings
Chairman, Committee on Commerce,
Science, and Transportation
United States Senate
Washington, D.C. 20510-6125

Dear Fritz:

Thank you for the opportunity to testify at the Commerce Committee's September 22 hearing on airline concentration at hub airports. I was pleased to state the Department's views on recent developments in the airline industry to clear up some misconceptions about our merger policy and to have a frank exchange of views with you and your colleagues on the Committee.

I have enclosed my responses to your post-hearing questions. As I stated at the hearing, I believe airline deregulation has been an enormous success. I hope my responses to your questions clarify some of the issues you have raised about competition in the airline industry.

Sincerely,

A handwritten signature in cursive script, appearing to read 'Jim', is positioned above the printed name 'Jim Burnley'.
Jim Burnley

QUESTIONS OF THE CHAIRMAN AND THE ANSWERS THERETO

QUESTION 1: Mr. Secretary, much of the discussion today will focus on fares at monopoly hubs. Yet, there is an even greater problem for medium-sized cities, like Charleston, South Carolina. If deregulation is working, why do these communities have fares so much higher than before 1978?

ANSWER:

Airline deregulation is providing enormous benefits to the traveling public, including travelers to and from medium-sized cities. Today, more than 90% of people traveling on airlines are flying on discounted tickets, up from 48% before economic deregulation. Average fares adjusted for inflation have declined 19.5% between 1978 and June 1988. As I indicated in my opening statement, a Brookings Institute study estimates that lower fares and better service saved airline passengers \$11 billion in 1987 alone over what would be the case if regulation had continued.

Air fares, as measured in constant dollars, are higher in some markets now than in 1978 and lower in others, reflecting the fact that air fares are based on cost, demand, and competitive conditions. Differences in fares across markets depend largely on the length of haul, traffic density, and the frequency of service demanded. These factors, in turn, determine the type of aircraft used. Because of cost differences among aircraft types, larger, more efficient aircraft are used on more heavily traveled medium- and long-haul markets. Thus, there are variances between markets, reflecting the costing factors as well as differences in the level of demand as mentioned above.

With these considerations in mind, we have examined the average fares for the nine most traveled Charleston markets to see what the change has been since 1979, the beginning of deregulation before carriers had complete control in setting fares. Average fares adjusted for inflation increased 9.4 percent during this period, or about one percent per year. This is not a especially large increase in fares, particularly since at the same time, passenger travel in these markets was up 41 percent indicating strong demand in the marketplace.

**AIR FARES IN SELECTED CHARLESTON, SOUTH CAROLINA MARKETS
FIRST QUARTER 1988 VS. FIRST QUARTER 1979**

Charleston --	1979-1Q		1988-1Q		
	Passenger	Avg. Fare	Passenger	Average Fare	
				Curr. \$	1979 \$
Atlanta	20,120	\$37	28,050	\$83	\$49
Boston	4,150	\$89	7,340	\$127	\$75
Charlotte	4,990	\$33	5,360	\$50	\$30
Chicago	5,840	\$76	9,880	\$155	\$92
Miami	5,530	\$66	5,080	\$112	\$66
New York (LGA)	7,190	\$75	14,960	\$112	\$66
Norfolk	5,710	\$52	5,230	\$131	\$78
Philadelphia	5,690	\$64	7,760	\$117	\$69
Washington (DCA)	9,550	\$59	13,150	\$96	\$57

Average Fare

1979-1Q: \$56
1988-1Q: \$103*

Average Fare in 1979 Dollars**

1979-1Q: \$56
1988-1Q: \$61
Average Increase: 9.4%

* Using 1979 passenger weights.

** First quarter 1979 Consumer Price Index = 100.

QUESTION 2: You and others argue that, because today's industry is more efficient, we should not re-regulate the airlines. However, in the name of equity -- especially for those passengers who have not benefited from deregulation -- why shouldn't we reregulate?

ANSWER:

As I indicated, there have been tremendous benefits from deregulation. Furthermore, most air travelers have shared in those benefits as evidenced by the size and scope of the service improvements, overall consumer savings and traffic growth that have occurred since 1978. Under deregulation, more markets are receiving competitive service and higher levels of service than before deregulation. Deregulation has also reduced the cost of air travel for millions of passengers, as evidenced by the fact that consumers saved an estimated \$11 billion on air transportation costs in 1987 compared to projected costs if regulation had been continued. That deregulation has been an enormous success is also demonstrated by the fact that domestic traffic has increased by 64 percent since 1978.

In addition, the air transportation system is more cost effective and better able to respond to changing market circumstances than before deregulation. This has enabled the system to become more efficient and dynamic, which is a major overall benefit affecting all communities.

We cannot expect any air transportation system to provide precisely the same degree of benefits to all segments of the population it serves. Deregulation, however, has proven to be an equitable economic system because it has provided wide range of price and service options which permit air travelers to choose the service which best meet their needs. Moreover, we should not re-regulate in the name of equity because deregulation has also proven to be a more productive and fairer than regulation. Regulation is inherently inequitable because it denies the consumer freedom of choice and because it imposes economic penalties on most consumers through governmental-directed cross-subsidization and other restraints on pricing and service initiatives.

Indeed, our forty-year experience with domestic regulation demonstrates that the substitution of governmental controls over air transportation for market-oriented decisions adversely affects most consumers by forcing them to pay higher prices and to accept inferior service than would be available under deregulation. It should also be noted that in the first nine years of economic deregulation, fatality rates have declined 48% for the major carriers compared to the last nine years of economic regulation. The fatality rate for commuter carriers has declined 36% during the same period.

QUESTION 3: In his testimony later today, Dr. Kahn will suggest that in recent years, predatory pricing has occurred in the airline industry, and that the Federal government has ignored it. Do you agree? If not, can you tell us what happened to all of the new-entrant, low cost carriers of the early 1980s?

ANSWER:

There are several reasons why a number of new-entrant carriers failed. Some were undercapitalized and did not have the financial resources to compete over the long-term with established carriers. Other new-entrants made poor business decisions, such as expanding their service networks too rapidly, without the support organization to provide and maintain service. In addition, the major carriers took steps to become more competitive by reconfiguring their route networks into hub-and-spoke systems, reducing their costs and increasing their labor productivity and equipment utilization.

Nonetheless, several new-entrants -- Braniff, Midway, America West and Southwest -- have remained viable competitors, attracting traffic in markets and at hubs where incumbent carriers have had a strong foothold. There is no evidence that the failure of new-entrants to maintain operations was the result of predatory pricing by incumbent carriers.

QUESTION 4: Much of the debate in the aviation industry today is on taking actions necessary to improve deregulation. Your statement today has been silent on such policy changes. What would you recommend the next Secretary of Transportation do to improve the level of competition in the airline industry?

ANSWER:

The Secretary of Transportation has adequate authority to handle any competitive issues that may arise in the air transportation industry. Section 411 of the Federal Aviation Act authorizes the Secretary to prohibit unfair methods of competition. The Act also gives the Secretary broad rulemaking authority to carry out his responsibilities. As you know, the Civil Aeronautics Board Sunset Act of 1984 provides for the sunset of section 408 at the end of 1988. Therefore, beginning January 1, 1989, airline mergers will be reviewed by the Department of Justice.

Our current economic policies and regulations are designed to give airlines the opportunity and incentive to compete vigorously, improve service and lower costs to the public. At this time, I see no need for any significant changes in the area of economic regulations to accomplish these goals.

There are three major areas that do warrant continued close attention to ensure that competition remains healthy and is promoted. The three areas of concern are airport access and air system capacity, airline-owned computer reservation systems (CRSs), and international air transportation developments.

Competition in the domestic air system is dependent on the ability of the airlines to inaugurate service at airports, enter new markets and provide sufficient levels of service to meet demand and be competitive with other carriers. With the explosive growth in air service over the past decade, the demands on the air system's capacity, both ground-side and air-side, have increased correspondingly. We have taken a number of steps to respond to this development. For example, we are currently in the process of upgrading the air traffic control and air navigation system under the National Airspace System Plan. In addition, the FAA has taken steps to improve the utilization of landing paths at a number of airports. We also have taken steps to increase the number of air traffic controllers and to position them at airports with greater need for additional staff. In these regards, efforts should be made to streamline the procurement processes at the FAA and to provide more flexible work rules for meeting air traffic controller staffing needs.

Regarding the CRS's, these systems continue to have the potential to affect airline competition. We have taken action in the past to prevent CRS from being used in an anti-competitive manner, as discussed in our answer to your next question. We are also looking at a number of comprehensive issues regarding the CRS's and their impact on airline competition. While it may not be necessary to take any rule-making or enforcement action as a result of our investigation, the importance of CRS's systems in the marketing and competition of airlines indicates that the Department must continue to monitor developments in this area and ensure that the systems are not utilized in an anti-competitive manner.

In the area of international aviation, there are a number of significant issues affecting airline competition. First, there are a number of pending complaints about unfair practices of foreign airlines regarding withholding of ticketing rights from U.S. carrier CRS's. This is placing U.S. carriers and their CRS systems at an unfair competitive advantage. Second, several multi-carrier CRS's are being developed in Europe and Asia that will have a major effect on the air transportation systems in those areas. The rules governing CRS's in Europe are currently being drawn up. The new Secretary should work to ensure that these developing systems and rules are pro-competitive. Finally, in certain bi-lateral relations, we need to encourage more equitable access and opportunities for U.S. carriers and fairness in user fees for U.S. carriers.

QUESTION 5: The General Accounting Office will argue that one of the greatest barriers to entry into the current airline industry is computer reservation systems (CRSs). GAO argues that DOT must take remedial action on the CRS issue to improve airline competition. Do you agree that the CRS issue necessitates governmental action? If not, why not?

ANSWER:

The DOT will soon complete a major study of the CRS industry. Our study will find that while CRSs provide their airline owners with certain competitive advantages, non-CRS-owning airlines also have competitive advantages. Moreover, by making a tremendous amount of fare and service information available to the traveling public, CRSs may actually encourage entry, since information on a new entrant's flights and fares will be made available on an ongoing basis to a large number of travel agents.

At this stage in the evolution of the industry, we believe it is appropriate to proceed cautiously before adopting any additional regulations that would reduce vendors' incentives to upgrade or market their systems. The Department's CRS rules are working well, and DOT has taken action in the past to prevent CRSs from being used in an anticompetitive manner. For example, we took enforcement action against and subsequently reached a consent agreement with a vendor regarding biased displays. In another instance, we reached a voluntary agreement with vendors to eliminate biased "secondary" display screens. And recently, we reached an agreement with vendors to eliminate rollover provisions in new subscription contracts.

Market forces are also transforming the structure of the CRS industry. For example, TWA's sale of 50 percent of its PARS system to Northwest and United's more recent sale of a 50 percent interest in its APOLLO system to a group of airlines highlight a trend toward the separation of airline and CRS operations and the entry of carriers into the CRS industry. Also, the CRS industry is becoming more "international," with foreign and domestic air carriers combining in consortia to provide CRS services in Europe and Asia, and with other U.S. vendors entering those markets on their own.

We now have pending before the Department several complaints and petitions for rulemaking dealing with CRS issues. The issues raised in these complaints and petitions are various and many overlap, but most deal with changes in the Department's regulations concerning contractual relationships between vendors and travel agents. These complaints and petitions will be explored thoroughly and expeditiously, consistent with the complexity of the issues involved.

QUESTION 6: Our last panel today will argue that the Federal government should prohibit exclusive-use airport leases and majority-in-interest clauses that effectively allow incumbent airlines to limit competition at an airport. What has been DOT's position on this issue?

ANSWER:

The long-term lease arrangements between airport management and airline tenants for gate and ticketing space differ widely from one airport to another. In some of these contractual arrangements, the airlines have insisted upon a majority-in-interest provision, which in varying degrees gives them approval power over future airport terminal expansion or development.

These provisions are included in the lease contracts and are invoked by airlines in order to prevent the airport management from undertaking frivolous or "gold plated" developments whose costs would eventually be reflected in the fees charged to the airlines. It is these fees and lease payments that are pledged as revenues to finance the developmental bonds.

The concern of opponents of these clauses is that incumbent carriers, by invoking these clauses, would be able to prevent airports from developing facilities to allow for entry by new carriers or expansion by smaller carriers at the airport. There is no evidence that these clauses have had such an effect.

Developments at St. Louis/Lambert Field demonstrate that airport authorities and carriers are able to expand facilities when there are majority-in-interest clauses in leases. Each of the last major terminal expansions was financed in a way that avoided the need for majority-in-interest approval. When TWA, the dominant carrier, wanted to expand its capacity, it agreed to lease exclusively and pay for the new gates and waiting rooms along the concourse expansion. Similar expansion was made for Ozark at St. Louis (prior to its acquisition). In addition, the Airport collected additional fees from concessionaires using space in the new facilities to cover costs. The airport authority has also utilized capital surplus accounts to finance construction.

Airport access is critical to the maintenance of a competitive air transportation system. Airport authorities, which negotiate lease contracts with air carriers, must be responsive to the needs of all carriers for access and expansion at their airports. It does not appear that exclusive-use and majority-in-interest clauses have adversely affected competition, as evidenced by the increase in the level of operations at most airports and the number of carriers serving them.

QUESTION 7: You stated that one reason fares are up in 1988 is that many aircraft are being replaced. Hasn't this been a continual process? Why do you make it sound like this is a new phenomenon?

ANSWER:

First, let me reemphasize that aircraft replacement costs are only one factor affecting air fares. Fares are a function of a variety of factors, the most important of which is probably the demand for service. 1988 has been a year of very strong demand for service, reflecting the continued economic expansion and the continued presence of affordable and convenient air transportation provided by deregulation.

I did not mean to imply that aircraft replacement is a new phenomenon. But the degree of replacement that we have seen in 1988 and the cost and financial commitment of airlines are greater than we have experienced in the past. From 1979 through 1984, the U.S. airlines ordered an average of 154 new aircraft per year. From 1985 through August 1988, they have placed orders for 345 new aircraft per year (annualized), roughly double the rate of the previous period. In fact, the airlines have already ordered 348 large jet aircraft in the first eight months of 1988, exceeding the total orders for 1987 (232 aircraft) and 1986 (315 aircraft). Not only have the airlines ordered aircraft in larger numbers, but the aircraft being ordered are more expensive. For example, the current version of the B-747 aircraft costs an estimated \$125 million, and a B-737 costs \$25 million.

Additional equipment will be needed to continue to accommodate the growing demand for air service. Revenues being generated at this time are necessary to meet the airlines' substantial finance need for that new equipment and other capital improvements. The current developments in the airline industry are similar to those experienced by other competitive industries: during a period of high demand, prices and revenue rise, higher utilization of production capacity is achieved, greater profits are realized, and companies invest in new productive means (aircraft) to increase supply (capacity) for further growth. Thus, the increased demand for air transportation and the corresponding increase in revenues and expansion of operations will be beneficial to the traveling public and the further development of our air transportation system.

QUESTION 8: Isn't one of the greatest cost increases of the airline industry the debt that was accumulated during the recent wave of mergers and acquisitions?

ANSWER:

As of June 30, 1988, the major carriers' long-term debt burden totaled \$16.3 billion compared to stockholders' equity of \$12.3 billion, resulting in a debt-to-equity ratio of 1.3.

The increase in some carriers' debt burden has been due to a variety of factors in addition to the mergers and acquisitions. Carriers incur debt to invest in new aircraft, fund unprofitable operations and restructure their finances.

The data show, however, that the cost of debt for the major carriers is relatively small compared to their operating costs and that, as a percent of operating costs, it has declined since before the major mergers and acquisition. For the twelve months ended June 1986, the major carriers paid interest on long term debt and capital leases totalling \$1.31 billion. For the twelve months ended June 1988, the corresponding amount was \$1.64 billion. At the same time, total operating expenses for this group of carriers went from \$40.02 billion to \$51.91 billion. Thus, the ratio of debt servicing and capital leases to total operating expenses actually declined over this period for the major carriers, from .033 to .032.

The Department's authority to approve airline acquisitions and mergers will expire on December 31, 1988. Prior to that date, the Department will review such transactions pursuant to the statutory standards established in section 408 of the Federal Aviation Act. That section requires the Department to approve a merger unless it is likely to lessen competition substantially or is not consistent with the public interest. The statute explicitly states that the burden is on the opponents to the merger to show that it should not be approved.

In each merger or acquisition case that has come before the Department, we have evaluated each affected city-pair market in which the two carriers compete to determine if anticompetitive behavior and performance is possible and sustainable. Our analysis of competition in affected city-pair markets focuses on: (1) existing nonstop airline competition, (2) other categories of airline service (e.g., direct, online connecting, interline connecting), (3) potential entry on either a point-to-point or a "tag-entry" basis, (4) potential entry from regional air carriers, and (5) competition from other transportation modes. In making our determination, we place a great deal of emphasis on evaluating whether or not there are entry barriers in a particular market -- that is, restrictions on slots, gates, terminal facilities, or any other restrictions that could prevent an established carrier from expanding service or a potential entrant from initiating service.

In sum, our merger decisions are carefully researched and based on the latest and most accurate information about current industry conditions and projected trends, not on ten-year old assumptions about airline industry operations and competitive behavior.

QUESTION 2: As we all recognize, the airline industry has changed dramatically since 1978. Yet, according to GAO, DOT officials have testified that they did not see the need to re-examine the assumptions used relating to the competitive posture of the industry (such as economic barriers to entry) when approving mergers. Doesn't this suggest that DOT made uninformed or, at least, cursory decisions?

ANSWER:

I do not believe the Department has made "uninformed" or "cursory" airline merger decisions. Departmental staff monitor the airline industry on an ongoing basis, and we are, of course, aware of the industry's changing structure and air carriers' competitive practices. On the contrary, a close reading of the Department's merger decisions will demonstrate that we have not approved these mergers without understanding that the industry is evolving and that market conditions have changed over time.

It is also important to note that the vast majority of the 21 airline mergers and acquisitions the Department has reviewed and approved were not controversial. Five of the cases the Department reviewed involved a jet operator acquiring a small regional air carrier. Another five of the mergers we approved involved financially failing companies. They include: Midway-Air Florida, Southwest-Muse, United-People Express/Frontier, Texas Air-People Express, and Braniff-Florida Express. Of the remaining 11 applications, six involved mergers of large jet carriers not currently competing in a significant number of markets. Only one of the mergers in this category, the transfer to United of Pan American's Pacific Division, generated any controversy at all. The Department of Justice said that we ought to reassign one West Coast transpacific gateway, and we later considered that matter.

The remaining five mergers generated varying degrees of controversy. The Department initially disapproved the Texas Air-Eastern acquisition because it would have substantially reduced competition in the New York-Washington shuttle market. The parties were able to obtain the Department's approval only after providing another carrier -- Pan American -- with sufficient slots and facilities to permit effective entry and competition in that market. Two other cases raised serious competitive issues concerning the merger carriers' principal hubs -- Minneapolis/St. Paul and Detroit for Northwest-Republic and St. Louis for TWA-Ozark. All parties to the TWA-Ozark case supported approval of the acquisition except for the Department of Justice, which recommended conditional approval. The Administrative Law Judge assigned to the case found that the acquisition should be approved without conditions, and the Department agreed with his determinations.

QUESTION: Given the introduction of long range aircraft into the international transportation market, what can the United States do to facilitate the development of an international air hub for long range aircraft traffic on American soil? As long range aircraft make international travel more accessible and more available to Americans and other people around the globe, it would be in the United States' interest to create incentives for the establishment for international passengers switching at a domestic United States airport. I hope that our country's bilateral international air transportation policies and negotiations would reflect a desire to enhance the attractiveness of United States airports as hubs for foreign and domestic travelers flying internationally.

ANSWER:

The Senate Appropriations Committee report on the Department of Transportation 1989 appropriation bill directed the Department to conduct a study of the impact of new long-range aircraft on commercial air traffic patterns and to assess what steps the United States can take to facilitate the development of an international air hub to accommodate long-range aircraft traffic. The report is to be delivered to the committee by March 1, 1989. DOT staff are actively working on the report and we anticipate its completion by the specified date.

QUESTIONS OF SENATOR STEVENS AND THE ANSWERS THERETO

QUESTION: Given the introduction of long range aircraft into the international transportation market, what can the United States do to facilitate the development of an international air hub for long range aircraft traffic on American soil? As long range aircraft make international travel more accessible and more available to Americans and other people around the globe, it would be in the United States' interest to create incentives for the establishment for international passengers switching at a domestic United States airport. I hope that our country's bilateral international air transportation policies and negotiations would reflect a desire to enhance the attractiveness of United States airports as hubs for foreign and domestic travelers flying internationally.

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To move things along and to expedite and try and help everybody out on the schedules, I will call the next two witnesses that we originally had scheduled separately to come up at this time. First we will recognize Mr. Kenneth Mead, the Associate Director, Resources, Community and Economic Development Division of the General Accounting Office, and Mr. Alfred Kahn, who has been in front of our committee on many occasions over the years. And we welcome you back again, Mr. Kahn.

And we will accept in full the statements of both of you for the record. I would ask that you each summarize at this time and we will try and move things along. First we will recognize Mr. Kenneth Mead. Welcome to you, Mr. Mead.

STATEMENT OF KENNETH M. MEAD, ASSOCIATE DIRECTOR, RESOURCES, COMMUNITY AND ECONOMIC DEVELOPMENT DIVISION, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY FRANK MULVEY; AND JAMES NOEL

Mr. MEAD. Thank you, Mr. Chairman. We appreciate the opportunity to testify today on the ongoing work about changes in the airline industry since the wave of airline mergers began in 1985. I would like to introduce my colleagues. On my left is Mr. Frank Mulvey and Mr. James Noel who directed our study of the effects of the TWA-Ozark merger on fares and service at the St. Louis airport.

Senator EXON. Welcome, gentlemen.

Mr. MEAD. As requested, our testimony today will address three areas: possible barriers to entry into the airline industry, the extent to which DOT's merger policies have contributed to increased concentration in the industry, and the effects of greater concentration on fares and service.

Our work to date indicates that, first, important changes in the airline operating environment since deregulation have made it more difficult for firms to enter the industry or for existing firms to expand into airports where another firm already dominates the traffic.

Second, DOT generally did not take into account several key changes in the industry when approving airline mergers. Consequently, the industry is more concentrated today than before deregulation.

Finally, the one merger we have studied to date, the Trans World-Ozark merger, indicates that consumers now have less choice among carriers on many routes and fares have risen.

I would like to address first the fundamental changes in the industry.

One of the most important developments in the industry has been the creation of hub and spoke networks. They generate significant economies of scale which, in turn, can permit lower fares. However, because airlines now focus their operations at hub airports, one or two airlines frequently dominate the traffic in many cities. This dominance is reinforced by changes in airline marketing practices such as computerized reservation systems, frequent flyer programs, travel agent commission overrides (referred to as

TACOs), as well as physical barriers, such as those Mr. Burnley was alluding to earlier.

Let me briefly highlight the potential effects of two of these: CRSs and frequent flyer programs. The development and widespread use of CRSs has been one of the most significant changes in this industry since deregulation. A recent DOT report on CRSs that was prepared in response to an earlier GAO study showed that airline-owned CRSs are earning profits exceeding those that could reasonably be earned in a competitive market.

The airlines owning the most widely used CRSs charge other airlines a fee for every flight segment booked by travel agents that use their systems. Those fees are about twice the cost of providing the booking.

The airlines owning these systems also earn revenues from a second source, from increased ticket sales because travel agents tend to favor the flights of the airlines whose CRSs they use. This is the so-called halo effect.

Airline-owned CRSs make it difficult for other carriers to compete at hub airports where the hubbing airline provides the CRS used by most travel agents in that market. The booking fees can raise the cost of potential entrants while the halo effect limits the available traffic base.

Finally, there are a number of restrictions in the CRS contracts with travel agents that limit competition in the CRS industry. We believe the evidence in the DOT study—and on this we take issue with the Department—is quite sufficient to warrant remedial action by the Department of Transportation.

Frequent flyer programs are designed to create brand loyalty and they benefit many air travelers. However, these programs can also make it more difficult for airlines to attract passengers away from an airline that already dominates traffic at a hub airport. An airline challenging a dominant carrier at its hub could offer a frequent flyer program of its own. But the hubbing carrier will typically offer the greatest variety of business and vacation destinations making its program more attractive. Therefore, even if an airline reduced its fares, it might be unable to capture many frequent flyers.

These changes, along with marketing tools and physical capacity constraints at some airports, have combined to make it more difficult for firms to expand into airports controlled by firms already in the market.

A decade ago when the airline industry was first deregulated, CAB developed a merger policy based on the assumption that the industry was relatively easy to enter especially after the principal barrier to entry, government regulation of fares, had been eliminated. CAB believed that the capital in the industry, the planes, was mobile and therefore could be moved from market to market depending on where profits would be greatest.

But changes in the competitive environment, such as CRSs and frequent flyer programs, make the assumption of easy entry considerably less persuasive than it was a decade ago. But since 1985, DOT has approved about 26 mergers on the assumption that it was easy for carriers to enter air travel markets. DOT tended to focus on the physical barriers to entry such as whether there are suffi-

cient gates available. Our point is that there are other barriers to entry such as the CRSs, frequent flyer programs, and travel agent commission overrides that should be considered in merger decisions.

As a result of these mergers, the industry is more concentrated today than it was at the time the industry was deregulated. Prior to deregulation, the five largest carriers controlled 69 percent of the market. By 1985, just before the merger wave, that share had fallen to about 57 percent. But as of June of this year, the five largest carriers had 74 percent of the market.

We believe that merger analysis ought to include the full range of factors affecting entry into the airline industry, and we are hopeful that when the authority to approve mergers is transferred to the Justice Department, that the full range of factors will be considered.

Now let me turn to the Trans World-Ozark merger and our study of the impact on average fares and services at Lambert Airport in St. Louis. Trans World's share of passenger boardings in St. Louis rose from 57 to 82 percent as a result of the merger. Overall, we found that there was little change in the level of service, but air travelers at St. Louis now have considerably less choice among airlines in many markets served out of St. Louis.

Trans World's average fares for 67 major St. Louis routes rose 13 to 18 percent. The fares of other carriers on 53 St. Louis routes where they were in competition with Trans World rose about half that amount.

According to Trans World, the relatively large fare increases we observed in 1987 reflect depressed fares in 1986. In response to traffic losses due to a flight attendant strike and a well-publicized terrorist incident, Trans World issued discount coupons system-wide, not just at St. Louis, that authorized 20 to 30 percent off the regular fare if redeemed.

Trans World officials acknowledged to us, though, that part of the reason why fares were low in 1986 was that Trans World and Ozark were competing vigorously before the merger. The merger, of course, eliminated that competition.

Finally, Mr. Chairman, the airline industry was deregulated because it was believed to be a fundamentally competitive industry that was relatively easy to enter and exit. Deregulation has produced many benefits. More people fly today than ever before, and fares, after adjusting for inflation, at least on average, remain at historical lows.

However, there have been important changes since deregulation that cause us to question whether the assumptions of the past are still valid. If the benefits of deregulation are to be preserved, the industry must remain competitive and the barriers to entry must be reduced.

We are currently studying the impacts of other mergers on fares and services at other airports at the request of Mr. Danforth. This morning, the Chairman of the committee asked us to look at mid-sized airports as well. We hope to be able to provide a more definitive answer to merger impacts when that work is complete, but we believe that the evidence on computer reservation systems, is already sufficient to warrant DOT opening a rulemaking proceeding.

With respect to merger oversight, we anticipate that the Justice Department will be taking into account the full range of factors that affect barriers to entry.

Mr. Chairman, that concludes my statement.

[The statement and questions and answers follow:]

STATEMENT OF KENNETH M. MEAD, ASSOCIATE DIRECTOR, RESOURCES, COMMUNITY,
AND ECONOMIC DEVELOPMENT DIVISION

Mr. Chairman and Members of the Committee: We appreciate this opportunity to testify on our ongoing work studying changes in the airline industry since the wave of airline mergers began in 1985. As requested by the Chairman, our testimony will address the possible barriers—economic and physical—to entry into the airline industry and individual markets; the extent to which Federal policies have contributed to the trend towards increased airline concentration; and the effects of airline concentration on airline fares and service.

At the request of several congressional committees, we have been studying the changes in the airline industry that have occurred since deregulation. Our work has proceeded along three lines of effort which parallel your request. Briefly summarized, the important observations from our work are:

Significant changes in the airline industry have made it more difficult for new or existing carriers to enter markets where other carriers are already dominant. Reduced competitive opportunities could eventually lead to higher fares for consumers.

The Department of Transportation (DOT) developed its merger policy based on outdated assumptions about the ease of entry into airline markets. It approved 26 mergers without reexamining the assumptions underlying its policy.

As a result of the mergers that occurred between 1985 and 1988, the airline industry, on a national basis, is more concentrated today than it was when the industry was deregulated in 1978. In 1978, the 5 largest carriers handled 69 percent of national air travel; today they handle 74 percent. At some airports, one airline handles more than 80 percent of all passenger boardings.

Regarding the effects of increased concentration, the evidence from the one case we have examined—the changes in fares and service levels at St. Louis following the Trans World Airlines' (TWA) merger with Ozark Air Lines—shows that while service levels were largely unaffected, consumers now have less choice among carriers and fares have risen. While we have not isolated what portion of the increase is due to the merger, TWA stated that the fare increases resulted from several factors that depressed fares in 1986, including intense competition with Ozark.

FUNDAMENTAL CHANGES IN THE AIRLINE INDUSTRY HINDER MARKET ENTRY

Deregulation allowed airlines to compete on the basis of fares, opened up the airline industry to new entrants, and allowed existing carriers to expand their operations. In the early years of deregulation, a number of low cost carriers entered the industry, and competition, on many routes, intensified. Since deregulation, the annual rate of return on investment for U.S. scheduled airlines has fluctuated between 2.1 and 9.9 percent.

The established carriers responded to the new competition and adopted a number of changes in their operating and marketing strategies. One of the most important changes in the airline industry was the shift away from point-to-point service to hub-and-spoke systems. Hub-and-spoke systems allow airlines to achieve operating efficiencies. By combining traffic from a number of spokes at a hub airport, airlines can better fill their planes, resulting in lower costs which, in turn, permit lower fares. Airlines with hub-and-spoke operations offer a large number of flights at the hub airport for passengers making connections to flights to and from spoke cities. On the other hand, hub-and-spoke systems typically result in only one or two carriers handling most of the boardings at a hub airport. Hub-and-spoke systems, to some extent, prevent new entry at the hub airport. Generally entry by other airlines that does occur is usually limited to service to and from another airline's hub.

In concert with the establishment of hub-and-spoke networks, other fundamental changes in the industry occurred, some of which reinforce an airline's market power at its hub airports. These include development of computerized reservations systems (CRS), establishment of frequent flyer programs, and reliance on travel agent commission overrides. These changes in how airlines market their services make it more difficult for new entrants to compete with the established airlines or for existing carriers to expand their operations to compete with another carrier at its hub

airport. Physical barriers, such as gate availability and landing slot restrictions, can also limit entry.

COMPUTERIZED RESERVATIONS SYSTEMS

On September 14, 1988, we testified before the Subcommittee on Aviation of the House Committee on Public Works and Transportation on the findings of a recent DOT report on CRSs prepared in response to a GAO recommendation.¹ We testified that the DOT report showed that airline-owned CRSs are earning profits exceeding those that could be reasonably expected in a competitive market and that these profits reduce competition in the air passenger market because they artificially raise the costs of other participating carriers. We conclude that the evidence warrants remedial action by DOT.

Most travel agents use a CRS to sell tickets. There are five systems, all airline-owned. The two largest, American Airlines' SABRE and United Airlines' Apollo systems, control 75 percent of the CRS market. Two years ago, we reported on possible anticompetitive impacts of CRSs. We focused our attention on two issues—incremental revenues, the extent to which the airlines that own these systems are able to capture a disproportionate share of the air travel market because agents using CRSs tend to favor the flights of the CRS provider; and booking fees, the charges that airlines must pay to the CRS owner every time a flight segment is booked on its system.

Incremental revenues could potentially weaken the ability of rival airlines to compete effectively. Booking fees, if they exceed costs, could have anticompetitive effects when paid by one airline to a competing airline. At the time of our earlier report, we did not have sufficient information to determine whether incremental revenues persisted or whether booking fees exceeded costs. Accordingly, we recommended that DOT determine the size and persistence of incremental revenues and examine the potential anticompetitive effects of booking fees.

DOT issued its report in May 1988. Although it made no recommendations, DOT's analysis showed that the CRS-owning airlines continued to earn substantial incremental revenues from their systems. According to the report, for the two major CRSs, booking fees are about double the cost of providing the service, including the cost of capital and a 15-percent return on investment. The revenue transfers from non-CRS vendor airlines to CRS-vendor airlines have been substantial, and these result in lost income for the non-CRS owning airlines. Further, there is no competitive market to determine the level of booking fees. If an airline refused to pay the fee of one of the vendors, it would effectively forfeit any business from travel agents using the CRS. For example, in 1984 Continental Airlines declined to pay the fees of one of the smaller vendors for six weeks. Continental Airline officials told us that revenue losses were so great that they believed they had to resume paying the fees.

Airline-owned CRSs also make it more difficult for a new carrier to enter the industry or for an existing carrier to expand into the hub of an airline that owns the CRS used by most travel agents in that market. New carriers often try to enter the industry by offering fares below those of the incumbent airlines. However the booking fee charges they incur raise the new carrier's costs relative to those of CRS-owning established carriers and reduce the opportunities for profitable entry. Further, if a hub airline owns the CRS used by most agents in the market, any airline attempting to compete at that hub will find itself at a competitive disadvantage. Local travel agents will tend to favor the flights of the airlines providing the CRS because of the airline's maintenance of supportive business relationships with its network of subscribers, the so-called halo effect. The potential competitor will also have higher costs because of the booking fees. Reduced access to air travelers and higher costs could combine to frustrate entry, even when the route that has been targeted for entry is highly profitable.

FREQUENT FLYER PROGRAMS

Every major carrier has a frequent flyer program which is designed to create brand loyalty. Because awards are earned only after certain mileage thresholds are reached, the traveler who has collected some, but not all, of the mileage needed to earn a bonus would be less likely to switch to another airline. Mileage accumulated on one airline is more valuable than the same mileage accumulated on several airlines. These programs have benefitted consumers, but they can also make it difficult

¹ Airline Competition: Impact of Computerized Reservation Systems (GAO/RCED-86-74, May 9, 1986).

for a new entrant to attract passengers away from an incumbent. Moreover, since frequent flyers are often business travelers whose fares are paid by their firms, they may be less responsive to the lower fares or improved service offered by carriers trying to enter the market. Finally, while a new entrant could offer its own frequent flyer program, it will find itself at a disadvantage at an incumbent's hub airport simply because the dominant carrier is likely to offer the greatest variety of business and vacation destinations making its frequent flyer program more attractive.

TRAVEL AGENT COMMISSION OVERRIDES

The airlines often pay commission overrides, which are paid in addition to the standard commission. These override commissions are incentives to travel agents to increase bookings on the flights of the sponsoring airline. Any airline can pay override commissions, but because they often apply to total agent sales, override commissions from an airline that dominates a hub airport are worth more than override commissions paid by other carriers. Override commissions tend to be less costly for a carrier that already dominates traffic at an airport, since to influence travel agent behavior, it need only pay overrides on a small share of its bookings or pay a lower override rate on total bookings. A smaller carrier with less presence in a city will often have to pay higher override rates or commissions on a higher share of its bookings. Thus, commission override arrangements also make it more difficult for new carriers to enter or for existing carriers to expand their operations to serve an airport where another carrier has established its hub or is otherwise dominant.

PHYSICAL BARRIERS

In some cases, there simply is no physical airport or airway capacity left for a new carrier to enter the market. At four airports, air traffic congestion has become so severe that landing rights (slots) can only be obtained by purchasing them from incumbents or at slot auctions. At other airports, additional operations can be accommodated, but gate space is insufficient. In addition, airports where carriers have established hubs often enter into long-term lease agreements with those carriers. For example, TWA has a long-term lease agreement that gives it exclusive use of 58 of the 81 gates at Lambert Airport in St. Louis. No other carrier controls more than three gates. The airport cannot build new gates without additional bonding authority from the voters. Moreover, majority-in-interest clauses in TWA's lease guarantee TWA a major voice in any decisions to expand or improve the airport that would require it to share the cost. There is evidence that hub airline control over airport access, such as TWA's at St. Louis, is not uncommon.

DOT OVERSIGHT OF MERGERS

When Congress deregulated the airlines, it directed the Civil Aeronautics Board (CAB) to analyze airline mergers in the same way that courts analyze unregulated industries. The Congress expected CAB to take into account competitive conditions. In the decade since deregulation, the industry has undergone significant changes, most of which were well underway when DOT inherited merger oversight responsibility from CAB on January 1, 1985.

CAB'S MERGER POLICY

CAB believed airline merger analysis should focus on the role of potential competitors, rather than existing competitors, as the force that restrains an incumbent firm from charging monopoly prices in markets it dominates. In CAB's view, an analysis of whether a merger is anticompetitive should focus on barriers that make it difficult to enter a market.

CAB developed merger guidelines based on several assumptions about the nature of competition in the airline industry at the time the industry was deregulated. CAB believed that airline markets were relatively easy to enter largely because capital (i.e. the airplanes) was mobile and could readily be shifted from one market to another. Therefore, with the elimination of government regulation over market entry, CAB believed that airlines could shift resources to any markets where airlines, facing little competition, were charging high fares and earning monopoly profits. Even if there were only one airline in a market, the threat of competition from other airlines would keep the incumbent airline from raising fares.

In federal court, once merger opponents show a merger will result in a highly concentrated market, the proponents must demonstrate that the merger will not be anticompetitive. This places the burden of proof on the merging firms. CAB, as a

regulatory agency, used a different standard based on its view that although airline markets are nearly always concentrated, the potential of new entry made concentration less important than in other industries. Consequently, in the airline industry, the opponent must bear the burden of proof, even when the merger results in highly concentrated markets.

CAB's perception of the ease of entry into airline markets may have been accurate for conditions at the time the industry was deregulated, but by 1985 when merger authority was transferred to DOT, changes in the airline operating environment made the presumption of easy entry less persuasive. These changes led former CAB officials, DOT economists, and airline industry analysts to challenge the assumption of easy entry.

DOT ADOPTED CAB'S ASSUMPTIONS

Since 1985, DOT reviewed and approved 26 merger applications. In implementing its merger policy, DOT assumed, as had CAB, that airline markets were easy to enter. According to the former Deputy Assistant Secretary for Policy and International Affairs, DOT did not examine the new developments in the airline industry despite concern by DOT analysts about the continuing validity of the assumptions. The only potential barriers to entry that DOT considered were physical barriers, such as the availability of gates and landing slots.

In the 1987 USAir-Piedmont case, the barriers-to-entry such as computerized reservations systems and frequent flyer programs, that had led many analysts to question continued reliance on the assumption of easy entry, were explored. In that case, the merger opponents showed that a significant correlation existed between airport concentration and airline fares, suggesting that airlines were not restrained by the threat of potential entry. After reviewing the evidence, the Administrative Law Judge found that these changes in the airline operating environment restricted entry, held the merger to be anticompetitive, and recommended against it.

DOT rejected the judge's recommendation and approved the merger. DOT did not look at how marketing tools, like frequent flyer programs, could keep competitors out of an airport dominated by an airline with a hub there, but looked instead at whether competitors could readily fly routes between cities. New marketing techniques, in DOT's view, did not preclude entry into individual routes.

While we did not evaluate the correctness of individual merger decisions, we believe that merger analysis should include the full range of factors affecting entry in the airline industry, such as computerized reservation systems and frequent flyer programs. Under the CAB Sunset Act, the Department of Justice will assume responsibility for airline mergers in January 1989. The Department of Justice, in opposing several of the mergers, expressed the view that many airline markets could not be easily entered because barriers to entry.

EFFECTS OF MERGERS ON FARES AND SERVICE AT HUB AIRPORTS

As a result of the 26 mergers since 1985 concentration in the airline industry increased dramatically, making the airline industry more concentrated today than before deregulation. In 1978, the 5 largest carriers controlled 69 percent of the nation's air travel market. By 1985, their market share had fallen to about 57 percent as many new firms entered the industry. However, as of June 1988, the five largest carriers controlled 74 percent of the market. Several economic studies have shown that, when individual routes are highly concentrated, fares are higher. Furthermore, several airports have become highly concentrated as a result of mergers. For example, after Northwest Airlines merged with Republic Airlines, Northwest accounted for more than 80 percent of passenger boardings at the Memphis and Minneapolis-St. Paul airports.

We are currently evaluating fare and service changes following mergers at a number of major airports affected by mergers. In response to a request from Senator John C. Danforth, we recently analyzed the changes in average fares and services at Lambert-St. Louis International Airport following the acquisition of Ozark Air Lines by TWA in late 1986. While service levels were largely unchanged, travelers now have less choice among competing airlines in many markets and TWA's fares increased.

At the time of the merger, TWA handled almost 57 percent of the passengers enplaning at Lambert, while Ozark handled 26 percent. No other carrier had as much as 3 percent of the market. The merger left TWA with 82 percent of the enplanements and Lambert rose from the tenth to the fifth most concentrated of the nation's 50 busiest airports.

The merger did not have much impact on the level of service available to St. Louis air travellers. What did change was the amount of competition on many St. Louis routes. The number of direct routes served by only a single carrier (usually TWA) increased 42 percent from 60 to 85. At the same time, the number of routes served by two or more carriers fell from 64 to 36, and those served by four or more airlines fell from 15 to 7.

With respect to fares, we compared TWA and Ozark's average round trip fares during three quarters of 1986 with TWA's fares for corresponding periods in 1987. We found that TWA's fares on 67 major St. Louis routes rose 13 to 18 percent. Fares of other carriers competing on the same routes rose a little more than half as much. By comparison the airline fares component of the Consumer Price Index increased 5 to 6 percent during this period.

According to TWA officials, the relatively large average fare increases in 1987 reflect depressed fares in 1986. In March 1986, TWA's flight attendants went on strike and TWA was forced to reduce service offerings, such as hot meal service. To win back passengers, TWA offered discount coupons worth 20 to 30 percent off the regular fare. TWA also fell victim to a widely publicized hijacking, and TWA officials believe that this probably affected some of its high yield traffic. Finally, according to the officials, TWA was in the midst of a competitive struggle with Ozark in 1986. In 1987, following the merger, these factors depressing fares abated and, in addition, TWA average fares rose as it began offering first class service in markets where Ozark had offered only coach service.

We did not separate the various influences on TWA's fare increases to determine the proportion of TWA's fare increases at St. Louis that was due to the merger. However, TWA officials acknowledge that part of the reason why fares were low in 1986 was that TWA was competing vigorously with Ozark before the merger, and that fares had fallen to levels that were not sustainable. The merger eliminated that competition and its effect on fares.

When our studies of other mergers are complete, we hope to be able to provide a more definitive answer on merger impacts.

CONCLUSIONS

Deregulation was predicated on the assumption that competition in the airline industry would be healthy and would result in benefits for the consumer. Many of the benefits expected from airline deregulation, such as lower fares in well traveled markets, have been realized. However, as evidenced by the growing concentration in the industry and by DOT's study on CRSs, fundamental changes in the airline industry threaten the benefits of deregulation.

We believe the evidence on CRSs is sufficient to warrant DOT opening a rulemaking proceeding to evaluate and adopt appropriate solutions to the problems posed by the revenue transfers from non-CRS-owning airlines to CRS-owning airlines. With respect to merger oversight, we anticipate that the Justice Department will take into account how changes in the airline operating environment affect the ability of firms to enter airline markets. If substantial barriers to entry exist at many of the nation's hub airports, the dominant carriers may be able to raise fares and earn monopoly profits without fear of potential competitors entering the market.

With respect to other barriers to entry, we are not yet in a position to recommend what actions, if any, will be either necessary or appropriate to preserve the competitiveness of the industry. As a general observation, however, we believe that our studies, both completed and ongoing, indicate the importance of monitoring the effects of recent changes in the industry to ensure that the nation's airline industry remains fundamentally competitive.

Mr. Chairman, that concludes my statement. I would be happy to answer any questions you might have.

QUESTIONS OF THE CHAIRMAN AND THE ANSWERS THERETO

1. Q: I remain convinced that many of the medium-sized communities in this country are paying substantially higher fares today than before deregulation. Aren't cities like Charleston, South Carolina, much worse off with respect to fare increases than major hub airports like St. Louis?

1. A: We believe that the potential for fares above what is necessary to cover costs and provide a fair return on invested capital is greater in markets where one carrier dominates and there are substantial barriers to entry. Hub airports, like St. Louis, are often dominated by a single airline and this dominance, combined with control over physical facilities and marketing practices designed to keep out potential competitors, allows the hubbing airline to charge higher fares. It is competitive potential, rather than city size or route distance, that will determine whether fares reflect the cost of providing the service. We have not examined the specific situation at Charleston, South Carolina, however, our plan to review fare and service changes at a number of concentrated airports will include medium-sized, as well as, large airports.

2. Q: Some economists claim that before deregulation, fares in long-haul markets were subsidizing the short and medium trips, while now, the reverse is true. Do you agree with this point of view?

2. A: Most studies of fare changes since deregulation show that, for the majority of travel, airline fares, after adjusting for inflation, have declined since deregulation. However, not all cities have benefitted equally. Fares in highly competitive transcontinental markets have probably fallen much more in real terms than fares in cities where there are fewer firms competing. Fares also are relatively higher, and occasionally even absolutely higher, on relatively short distance, less traveled markets than on long-distance, heavily traveled routes.

Under Civil Aeronautics Board (CAB) regulation, air fares were usually set below cost in short-haul and lightly traveled markets and above cost in longer haul and more heavily traveled markets. Since promotion of air travel was part of CAB's mandate, CAB believed that below cost fares were necessary on short-distance routes to encourage travelers in those markets to choose to fly. The Board set fares on a mileage-based formula which did not

reflect the degree to which cost per mile declined with distance. A 1974 evaluation of the formula by CAB found that air fares were below costs for flights up to a distance of almost 600 miles, and above costs for longer flights. As a result of these cross-subsidies, passengers in some communities received more air service at lower fares than they might have otherwise. On the other hand, fares were higher than necessary in the major travel markets.

With the elimination of fare and route regulation, airlines adjusted their fares to better reflect costs and competitive market conditions. Although some costs vary directly with distance, many do not and cost per mile declines as distance increases. Heavily traveled markets also permit the airlines to fly larger, more efficient aircraft which also lowers unit costs. In addition, passengers traveling greater distances are less sensitive to scheduled departure times, and so airlines can offer relatively fewer flights and achieve higher load factors than in markets where travelers require more frequent departures. This, too, reduces costs and allows lower fares.

While fares have risen in markets where they were historically below cost, some studies suggest in markets where fares rose, the increases were smaller than the reductions in markets where fares fell. For example, a 1983 CAB study found that fares for travel on lightly traveled routes of less than 400 miles were 14 percent above what they would have been under the old CAB formula. On the other hand, fares on the most heavily traveled routes of more than 1500 miles were about 40 percent less than what they would have been had the fares been set under the formula. Thus, far more travelers benefitted and they benefitted by much larger amounts than the losses experienced by travelers whose fares had risen.

3. Q: You stated that one reason fares have gone up at St. Louis is that in 1986, fares were held down by competitive battles between TWA and Ozark. Isn't this a telling comment on the benefits of competition, as well as its importance to consumers in holding down fares?

3. A: Yes. TWA contends that competition with Ozark was so intense that fares had been driven down to non-remunerative levels and that only one hubbing carrier could survive at St. Louis. We are not convinced that St. Louis could support only one hubbing airline. More likely, St. Louis travelers were benefitting from low fares and that, in the long-run, the carriers serving St. Louis would have adjusted their fares so that they were sufficient to cover costs and generate a reasonable return on investment.

4. Q: You mentioned a number of barriers to entry -- both physical and economic. In your view, what must be addressed most urgently by the Congress to ensure airline competition? What specifically should be done?

4. A: The Congress must ensure that the Department of Transportation and the Department of Justice, after it assumes merger authority in January 1989, take into account the changed air transport competitive environment when evaluating proposed mergers and developing air transportation policies. DOT has largely ignored non-physical barriers to entry in approving 26 airline mergers since 1985.

Except for airline-owned computerized reservation systems (CRS), we have not completed our work assessing other barriers to entry. Based on our assessment of conditions in the CRS industry, we believe that the evidence is sufficient to warrant a DOT rulemaking proceeding to address the problems associated with airline-owned CRSs.

5. Q: You strongly suggest the need for remedial action by DOT on the airline computer reservation systems. What are your suggested remedies?

5. A: As we testified on September 14, 1988 before the House Committee on Public Works and Transportation, Subcommittee on Aviation, we are not prepared at this time to recommend any particular remedy for the anticompetitive problems of the CRS market. There are several competitive problems in the CRS market, and no one remedy addresses all of them. In fact, a remedy for one problem may exacerbate another. Thus, multiple remedies may be needed. The following discusses the advantages and disadvantages of the different remedy options to assist DOT and the Congress in their consideration of them.

There are four major competitive problems that have been identified in the CRS market:

1. Booking fees that significantly exceed costs, which create distortions in the airline marketplace by raising the costs of air travel above the true cost.
2. Incremental revenues, which transfer revenues from non-CRS vendor airlines to CRS vendor airlines, and which limit competition in the airline industry by giving CRS-owning airlines an artificial competitive advantage.

3. Revenue transfers from non-CRS-owning airlines to CRS vendors caused both by booking fees which exceed costs and incremental revenues. These transfers also occur, to a lesser extent, from minor CRS vendor airlines, whose booking fee outlays exceed their booking fee revenues, to the two major vendors. To the extent that they exceed the costs of the services provided, these transfers reduce competition in the industry by artificially imposing a cost penalty on some carriers and subsidizing others. Such transfers could force non-vendors or minor vendors to exit (or avoid entering) markets where they could otherwise have been competitive.
4. Contract provisions that discourage travel agents from switching vendors. Such provisions directly reduce competition in the market for servicing travel agents, and also perpetuate the revenue transfers to major CRS vendors cited above, by making it more difficult for minor CRS vendors to sign up enough travel agents to prevent a net outlay of booking fees to the major vendors.

THE PROBLEM OF REVENUE TRANSFERS BETWEEN AIRLINES

The problem of revenue transfers between airlines can be addressed either by divestiture (requiring airline owners of CRSs to sell them to a non-airline owner) or by establishing an industry-wide airline consortium to operate a common industry system.

Divestiture

Divestiture would, by severing the link between an airline and a CRS, eliminate incremental revenues as well as transfers from one airline to another. Divestiture would not address the problem of high booking fees, because an independent CRS owner would have much the same market power as a CRS-owning airline and would be able to extract high booking fees from non-CRS-owning airlines. Divestiture also would not address the problem of travel agent contract terms which discourage switching from one vendor to another.

Divestiture could have the effect of raising booking fees. Since the owner would no longer have the opportunity to earn incremental revenues from the airline business, the owner might decide to increase booking fees to compensate for the shortfall. Without the potential for incremental revenues, the number of CRSs could also be reduced, increasing the CRS market's concentration. This could injure competition, and in particular might slow down the rate of technological progress in the industry, which some observers attribute to vigorous technical rivalry between vendors. On the other hand, a reduction in the number of CRSs in use might

reduce costs because of the economies of scale in operating a system.

Divestiture would probably lead to the development of separate internal reservation systems by the major CRS-owning airlines. The airlines that own CRSs do not maintain separate internal reservation systems; the CRS is their internal reservation system. If they were required to divest themselves of the CRS (and hence of their internal reservation system as well), they would probably feel forced to develop a new internal reservation system to replace the CRS. While some small airlines do not have any internal reservation system, we believe it is unlikely that any major airline would tolerate the loss of control inherent in having its reservation system totally in the control of an outside firm.

Developing a new internal reservation system would certainly increase the overall cost of the airline reservation system because it would involve some duplication. It might also inhibit the transfer of data from the airlines to the CRSs. Currently, the airline which owns a CRS has its data on flight schedules and seat availability automatically loaded into the CRS. If the CRS were separately owned, the data would have to be transmitted to the CRS and separately loaded. Some CRS vendors believe that this would reduce the timeliness and quality of the data in the CRS.

A Common Industry System

Ever since CRSs were first discussed in the late 1960s, there have been proposals to establish a common airline-owned nonprofit system for all travel agents and all airlines to use. These proposals have always failed because of disagreements between airlines on how to establish the system, and because of uncertainty about whether the system would enjoy antitrust immunity. It is apparent that such a system can only be established with government intervention, which is necessary both to compel the existing systems to be consolidated into a common system and to provide the assurance of antitrust immunity for the consolidation.

A common system would have many of the same advantages as divestiture. Since all airlines would jointly control the system, incremental revenues and inter-airline transfers would no longer be a problem. And since the system would operate on a nonprofit basis, high booking fees would also be eliminated.

The major objection to a common system is that there would be no rivalry between competing systems. Travel agents and vendors believe that rivalry between competing systems has led to technological improvements in the systems. Agents also feel that they get better service when systems are competing with one another. It is possible that some elements of competition could be incorporated into a common system. For example, independent hardware and software vendors might be able to supply individual

travel agents with components of the system, as long as those components were certified as satisfying the specifications of the system.

RESTRICTIONS ON BOOKING FEES

There are various ways in which booking fees could be limited. All have the effect of limiting or reducing high booking fees, and all, with varying degrees of success, address the problem of inter-airline revenue transfers due to high booking fees. None of them addresses the problem of incremental revenues, and none affects contract terms between vendors and agents. By forcing vendors to generate more of their revenues from agent subscription fees, all of these restrictions on booking fees would put added pressure on agents to shop for the best financial deal from vendors. Agents would probably pass the cost of higher subscription fees back to the airlines in the form of higher commissions on ticket sales. However, since CRS vendors have less market power in setting subscription fees than in setting booking fees, it is likely that the increase in subscription fees would be less than the reduction in booking fees, so that non-vendor airlines (and most airline passengers) would be better off. This would be particularly true if contract terms between the vendors and the travel agents were restricted to give the agents more bargaining power over the vendors.

One approach to limiting these revenues to reasonable levels would be to prohibit booking fees entirely, thus forcing the CRS vendors to derive their revenues entirely from the travel agents rather than from the airlines with whom they compete.

Alternatively, instead of requiring that booking fees be reduced to zero, DOT could require that booking fees be reduced to a level approximately equal to the costs of providing the booking, as estimated in DOT's recent report. Under DOT's most likely allocation of joint costs, it estimated that booking costs varied from \$0.75 to \$1.74. Under this approach, then, booking fees would be reduced from \$1.85 to a level somewhere in this range. This approach is less drastic than cutting booking fees to zero.

The disadvantage of this approach is that it requires administrative price regulation, which would involve a process of allocating costs between servicing travel agents and making bookings, estimating booking costs and travel agent service costs, and holding hearings to consider requests for fee increases. This, of course, is just the sort of rate-setting process that the Congress sought to avoid by deregulating the airlines.

A third approach would be simply to cap booking fees at their present level. This would allow the vendors to continue to receive the high booking fees which they now receive, but would not allow them to take further advantage of their market power in the

future. This approach has the advantage of simplicity, but results in an arbitrarily chosen maximum booking fee.

RESTRICTIONS ON COMPETITION IN THE TRAVEL AGENT SUBSCRIPTION MARKET

The market between the travel agents and the CRS vendors is more competitive than the market between the CRS vendors and the other airlines. A travel agent can choose between five different CRS vendors, but the agent's effective freedom of choice is limited by several factors.

Contract Length

First, the standard contract in the industry is for 5 years, the maximum permitted by the DOT rules. Minimum use clauses establish an expectation on the part of the vendor of receiving a stream of booking fees over the life of the contract. This expectation would form the basis of a damages suit if the agent breached the contract. Such provisions make it costly for an agent to break a contract significantly before the 5 years have expired. Some CRS vendors have offered to compensate agents for the cost of breaking these contracts, but the great expense of paying the resulting damages makes it unlikely that competing CRS vendors will make such offers except in selected markets. In the absence of such an offer, an agent in the middle of a 5-year contract, then, has little practical choice about which vendor to use, no matter how attractive a system a competing vendor might offer.

The American Society of Travel Agents (ASTA), as well as the smaller CRS vendors, argue that there is no business necessity for contracts to be as long as 5 years. The CAB originally allowed contracts of up to 5 years to allow agents to obtain the full benefit of investment tax credits. Since the CAB rulemaking in 1984, however, the investment tax credit has been repealed. The two largest CRS vendors argue that the vendor must have a 5-year contract to amortize equipment, installation, and training costs. However, they do not indicate why equipment must be amortized over the life of a single contract. Such equipment could conceivably be pulled from one travel agent's office at the end of a short-term contract and re-used in another's. Installation and training costs can be charged to the agent separately, giving the agent an incentive not to change vendors frequently. Vendors also state that they need long contracts to generate sufficient revenues from their agents because the subscription fees they charge the agents are so low. Vendors could compensate for shorter contracts by charging higher prices to agents.

One option, then, would be for DOT to amend its rules to reduce the maximum length of a travel agent's CRS subscription contract to a shorter period. ASTA has suggested reducing the maximum contract to 3 years. ASTA noted that, prior to the issuance of the CAB rule in 1984, the standard contract was for 7

years. The CAB rule reduced that term by 2 years, and ASTA suggests that a further 2-year reduction would now be appropriate. ASTA does not, however, offer any specific rationale for a 3-year term. The European Civil Aviation Conference (ECAC) has also recommended 3 years to its member states as the maximum contract term for CRSs in Europe. A separate proposal by the European Economic Community (EEC) would allow an agent to terminate a contract without penalty on 3 months notice.

Minimum-Use Clauses

One factor which could reduce the level of market power exercised by airline-owning CRSs over travel agents would be the prohibition of minimum-use clauses. SABRE and Apollo both have "minimum use" clauses in their contracts which require the agent to make at least 50 percent (or, in the case of SABRE, 75 percent) of its bookings on that CRS (based on bookings during the first 6 to 12 months of the contract). These clauses are intended to guarantee to the vendors a stream of income from the airlines in the form of booking fees. The agent is not responsible for payments of the booking fees during the contract's life. However, if the agent breaches the contract, he or she is responsible for the booking fees that the vendor would have received. Thus, the minimum-use clause causes the agent to become liable for damages that include not only the lost lease payments, but lost booking fees as well. In the absence of a minimum-use clause, agents could reduce their use of one system (while continuing to pay the subscription fee for the remainder of the contract term) and start using a second system. This would allow the agent to switch systems without incurring damages. It is not certain how effective the elimination of minimum-use clauses would be, since it is not clear how many agents would be prepared to have two sets of equipment in their offices.

Liquidated Damages

Travel agents have also been concerned about the burden of liquidated damages clauses. These clauses represent an agreement at the time the contract is signed regarding the damages that will be paid in the event the contract is breached. In CRS contracts these clauses generally require the agent to pay to the vendor a lump sum representing the stream of booking fees anticipated by the contract's minimum-use clause. They also require the agent to pay 80 to 100 percent of the remaining subscription fees owed on the contract, and in some cases any special bonuses paid to induce the agent to sign the contract. The heavy damages stipulated by these liquidated damages clauses could probably be imposed even if the clauses were not in the contract, because the lengthy contract term and the minimum-use clause in the contract create an expectation on the part of the vendor of a stream of revenues from the participating airlines. In the one case decided so far, the court upheld the reasonableness of damages based on this expected stream

of income. Elimination of the liquidated damages clause would therefore have little effect on damages unless the contract term or minimum-use clause were modified as well.

One option would be for DOT to regulate the provisions of liquidated damages clauses. For example, booking fee revenues, which are generally the largest element in the liquidated damages formulae, could be excluded as a permissible form of damages. DOT could also, as ASTA has proposed, prohibit liquidated damages clauses in the contract. ASTA acknowledges that, under existing contract law, the CRS vendor is entitled to some damages if the contract is broken. They believe, however, that the existing provisions are excessively favorable to the vendor, and that the agent has insufficient bargaining power to resist these provisions. They therefore believe the damages should be determined by a court if the contract is broken. As noted above, however, this prohibition would only have a significant impact on reducing damages if it were combined (as ASTA has proposed) with a reduction in the maximum contract term and/or in the minimum use of the system that could be required.

Remaining Competitive Problems

Even with shorter contract periods, mitigation of liquidated damages clauses, and elimination of minimum-use clauses, CRS vendors would still have significant market power over travel agents. In our conversations with travel agents, we have found several ways in which airlines use their market power as carriers to enhance their market power as CRS vendors.

The development of the hub-and-spoke system has given air carriers substantial market power in particular metropolitan areas. In some metropolitan areas, a single carrier provides 80 percent of the enplanements, and it is common to have a single carrier with over half of the enplanements. Travel agents have told us that carriers who dominate hubs use their market power to pressure travel agents into subscribing to their CRS. Carriers provide a number of free discretionary services to travel agents, such as free tickets, free use of VIP lounges, and the service of "breaking seats" (that is, making seats available to a favored customer even after the flight is fully booked). These services are most valuable when provided by the dominant carrier in the metropolitan area served by a particular agent. An agent who is refused these services because of an unwillingness to subscribe to the dominant carrier's CRS may not be able to compete for passengers. It would probably be difficult to end all these vestiges of market power in the relationship between the carrier and the travel agent.

6. Q: You stated that you believe the current hub-and-spoke system prevents the entry of new carriers at the hub airport. What should be done to increase opportunities for new entrants?

6. A: With the exception of CRS, our work has not progressed to the point that we can draw conclusions about the effects of other entry barriers or recommendations on how to reduce or eliminate them. It is not hub-and-spoke systems, per se, but airline marketing and operating practices in the hub-and-spoke operating environment that are the cause for concern. GAO is currently examining the effects of barriers to entry as well as fare and service conditions at a number of concentrated airports. We anticipate that as we complete these studies we will develop specific recommendations to the Congress and DOT to address airline competitive problems.

Hub-and-spoke operations afford the airline significant operating economies and provide travellers from smaller, nonhub cities a greater variety of destinations. It is not hub-and-spoke systems, per se, that frustrate entry into hub airports by new carriers or expansion by existing carriers, but the combination of a dominant presence by an airline at the hub and the existence of physical and marketing barriers to entry. A dominant airline in a market will always have some advantage over competitors simply because consumers may identify the airline with a particular market. Other carriers challenging the dominant firm will have to lure consumers away through lower fares or better service. In either case, the consumer benefits. However, a dominant firm at a hub airport might be able to insulate itself from competition by employing various marketing practices.

For example, if a hubbing carrier offers a frequent flyer program, it will be less vulnerable to competition from other carriers. Travelers who normally might have switched to the new airline will stay with the incumbent because they are trying to earn free travel or service upgrades. The hub airline is likely to offer the widest variety of both business and vacation travel destinations making its flights more desirable both in terms of the potential to earn awards and the value of the benefits.

Similarly, if a hubbing carrier is also a CRS provider, travel agents in that city will prefer to use that carrier's CRS system and they will be more responsive to override commission offers from the hubbing carrier. In addition, the hubbing carrier may be able to limit facilities availability through the majority-in-interest clauses in its contracts with the airport authority. Finally, it is important to recognize that these barriers act synergistically and care must be taken to ensure that partial solutions don't make the problem worse.

Senator EXON. Thank you very much. I think we will go to Mr. Kahn now, and then we will have our questions. Mr. Kahn, welcome.

STATEMENT OF ALFRED E. KAHN, PROFESSOR, CORNELL UNIVERSITY

Mr. KAHN. Thank you, sir, and thank you for your invitation.

I want to begin by pointing out the obvious: that we are not going to be able to develop sensible policies to solve the problem of hub domination and possibly monopoly exploitation without a sense of whether we think deregulation has been a good thing or not. So, I am going to spend one of my five minutes presenting one single fact.

Airline yields per mile—that is, the amount of money that airlines actually get on average per passenger mile—are now running

at about 1985 levels. That averaged 11.7 cents a mile. In 1976, which was the last year before the CAB began to permit a lot of discounting, it was 8 cents—8.0, 11.7. In that period, the consumer price index more than doubled. If airline yields had risen as much as the consumer price index, they would have been not 11.7 cents now but 16.7 cents. Multiply that by the 400 plus billion revenue passenger miles, you have a saving of \$20 billion a year. Now, that is an exaggeration for various reasons, but it still gives you an idea of the major consequence of deregulation.

I concede, of course, however, that these benefits have not been evenly distributed, and there does seem to be a problem of exploitation of some travelers—mostly non-discretionary business travelers who can't stay over a weekend but, by the way, get frequent flyer credits in exchange, out of hubs that are dominated by a single carrier. And, of course, that is what you are interested in.

I can be very brief about the principal reasons partly because Mr. Mead has already stolen most of my thunder, for which I am grateful because I have only a limited time for thunder.

One, of course, is the wave of mergers and code-sharing agreements not merely among the trunks, but between trunks and commuter carriers.

Number two, preferential access of the hub dominant carriers to the limited airport facilities, already mentioned.

Number three, the fact that competition takes the form of the airlines offering travel agents inducements to steer travelers their way, and as Mr. Mead has already pointed out, override commissions particularly, which increase in percentage terms with an increasing number or proportion of business thrown their way, are just like progressive quantity discounts. They create an almost irresistible temptation to throw traffic over to the dominant carrier.

Number four, the ownership of computerized reservation systems by the carrier dominating the traffic. The Department of Transportation report itself is very clear on that, and Mr. Mead has very accurately summarized it.

Number five, frequent flyer programs for exactly the reason that he has already mentioned.

And number six, the practice of giving deep discriminatory price cuts to meet competition.

Now, a lot of things can be said in favor of those discounts. It would be a terrible thing to try to ban them. But they have clearly been a major factor driving out of the market almost all of the new price-cutting competitors.

I have identified the main source of the problem. There are no simple solutions, I am sorry to say. All I can do is give you a checklist of possible ones to consider.

Number one, it is pretty much too late to try to close the barn door on mergers. I certainly agree that the authority should go to the Department of Justice. But the experience has a broader lesson. It tells us that the preservation of competition requires a government aggressively searching for, sensitive to all suppressions and impediments to effective and fair competition. And that I don't think we have had.

Number two, we clearly have to look for ways of eliminating or modifying preferential access of dominant carriers to airport facilities.

ties. And I am happy to see that you have a panel on the airport problem which follows—well, you are going to have it this morning or this afternoon.

Number three, one central way to do that is, as Senator Kassebaum pointed out, expand airport capacity. I want to put in a particular plug for reliever airports like Midway or Love Field because this would not only relieve congestion, but it could also provide a niche for successful smaller competitors who are there to serve the traffic that originates and terminates there. They are no good for connecting traffic, but it is precisely the travelers who begin their trips at the congested hubs and end them at the congested hubs who are in the most danger of exploitation. The travelers who go over the hubs and change planes there have plenty of alternatives. They can go over a zillion different hubs. It is the fares in and out of the hubs that are the problem, and that is where feeder airports could help—or reliever airports.

Number four, on travel agent commissions, at least require full disclosure to customers in a comprehensible form of who is paying the travel agents and how much.

Number five, I think we should at least require that computerized reservation systems show up immediately the lowest available fare between any two points to any customer who asks for it.

Number six, the computerized reservation system ownership problem which the GAO is handling I think very adequately and it is silly for me to get into it now. I continue to think that somehow we have to have a divestiture because of the distorting effect which DOT itself has found.

Number seven, I hate to mention it because I am sure it is a political hot potato. I would tax frequent flyer credits when they are earned by travelers whose fares are paid by their clients or their employers. I know it is tough politically. I know it is tough administratively, but the Federal budget deficit and the simple unfairness of not taxing this fringe benefit argue for it and so does its effect on competition in the airline industry.

Number eight, foreign competition. The only carriers who are likely or able to challenge a trunk dominating a hub will be another big one, and there just aren't very many American ones left. I would, therefore, open the door on a reciprocal basis, negotiating with foreign countries, to foreign airlines letting them own more than 25 percent of an American airline—they are prohibited now—where it can be shown that it would invigorate competition; for example, where the other partner is a new American airline or a struggling commuter or a struggling trunk that would otherwise have no alternative but to tie up with a trunk.

I do discuss in my testimony, finally—but my time is up—the possibility of price ceilings. I can't disagree with them in principle as an absolute last resort, but I certainly want to spend most of my energy urging you to be very cautious about it. Partial regulation of particular fares on particular flights involves a hopeless search for costs that cannot be separated. It is undoubtedly going to affect scheduling. If you reduce fares, you are going to have poorer scheduling, which is likely to hurt exactly the non-discretionary travelers that you are trying to protect, and it will also dry up the source

of discount fares. And I doubt that you want to contemplate the government getting into the business of dictating scheduling.

So, while I can't throw it out as an ultimate logical possibility, I have to see infinitely tougher evidence that there really is such a severe problem that we want to contemplate that kind of re-regulation.

Thank you very much.

[The statement and questions and answers follow:]

STATEMENT OF ALFRED E. KAHN¹

Mr. Chairman and Members of the Subcommittee: Last fall I had the privilege of testifying before this Committee in its hearings on airline safety and possible reregulation of the industry. I devoted a good deal of my testimony at that time to documenting my own conviction that airline deregulation had on the whole been a great success. The general deterioration in the quality of air travel, which particularly concerned the Committee at that time was, I argued, in large measure attributable to the failure of government to expand and efficiently ration our national traffic-handling capacity.

I do not propose to repeat that argument in this statement, but will instead concentrate on the subject of these hearings—the sharply increased concentration of the industry's traffic at major hubs, dominated by one or two carriers, and the monopolistic exploitation of travelers beginning and ending their trips at those hubs that it appears to have made possible.

I must point out at the outset that I have not conducted systematic research on the problem, and cannot therefore advise the Committee about how severe it is, or definitively prescribe remedies. What I will do is set forth what seem to me the principal sources of the problem and discuss a range of possible ways of attacking it.

Public discussion of the airline industry during the almost ten years that have elapsed since passage of the Deregulation Act has centered almost exclusively on the question of whether deregulation was or was not a mistake. In recent years, the focus has shifted—fruitfully—from retrospective to prospective, from the wisdom of what we did ten years ago to the question of what else we should have been doing since then, and what we should do now. And that is the focus of my testimony today.

At the same time, it is not possible to devise sensible new policies for the problems before us today without first having a conception of what the net effect of deregulation has been. I begin by asserting, therefore, what I believe to be the preponderant view of objective observers, that deregulation has been a success; that it has done most of the things its sponsors wanted and expected it to do; and that it would be a profound mistake to attempt to reimpose the pervasive restrictions on effective competition that were at the core of regulation as it was practiced by the Civil Aeronautics Board during its 40-year history.

The central fact is that average yields per passenger mile—the average of fares passengers actually paid—declined over 30 percent in real terms between 1976 and 1987, mainly because of the intense price competition that deregulation unleashed and the improved productivity that it induced. The very low prices in 1986 and 1987 were probably not sustainable; industry profits were negative in the former year and very modest in the latter. Yields are now running at 1985 levels, and the industry as a whole is now very profitable. But that still represents a price decline of almost 30 percent in real terms as of July 1988. If instead average yields had merely remained constant in real terms, travelers last year would have paid \$20 billion more for their tickets—in which event, of course, many fewer of them would have traveled.

By any test, the airline industry is today far more competitive than it was under regulation. Concentration has increased at the national level, but the significant concentration figures are on individual routes. A recent study by the Congressional Budget Office demonstrates that, despite the many mergers in the intervening period, the average number of carriers serving city pair markets actually increased between 1983 and 1987, and this increase was especially marked in the smaller markets, serving 25 to 50 and 51 to 100 passengers per day.² Since an earlier report to

¹ Robert Julius Thorne, Professor of Political Economy, Cornell University; Special Consultant, National Economic Research Associates; Chairman, Civil Aeronautics Board, 1977-78.

² *Policies for the Deregulated Airline Industry*, July 1988, p. 17.

Congress by the Civil Aeronautics Board³ demonstrated a sharp increase between July 1978 and July 1983 in the average number of carriers providing non-stop service in all the market categories that they studied, it is clear that effective market concentration has gone down, not up since deregulation.

Putting only these two facts together, I urge upon the Committee my own firm opinion, therefore, that whatever remedies we consider for such problems as have arisen, or that we can anticipate, must be compatible with preserving the freedom of competition that was the essential purpose of deregulation.

Whatever has happened to concentration in airline markets *on average*, and however great the benefits of price competition to the preponderant majority of travelers, concentration of the industry has increased at the national level; it has probably increased also on a significant number of routes—particularly for traffic originating and terminating at hubs dominated by one or two carriers—and deregulation has deprived those travelers of the protection of regulatorily-imposed price ceilings.

Even some advocates of deregulation recognized this danger: the original deregulation bill would have retained price ceilings on routes in which a single carrier had 90 percent or more of the traffic; and the CAB, while supporting the bill, recommended that the cutoff concentration ratio be reduced to 70 percent.

That particular provision was presumably dropped in the expectation or hope that the possibility of entry into those routes by other carriers, freed of the previous regulatory restrictions, in the event that fares got too high, would suffice to prevent intolerable exploitation. Those expectations were excessively optimistic. Every study of the behavior of airline fares since deregulation with which I am familiar shows that concentration among incumbent carriers produces higher fares, on average, and quite possibly markedly higher ones: this means that the *possibility* of competitive entry is not as powerful a protector of consumers as the actual presence of competitors.⁴

If the exploitation of travelers on such routes does turn out to be of sufficient moment to justify our considering governmental intervention of one kind or another, it would seem sensible to direct the remedial action at the causes of these increases in concentration and the obstacles to the free entry that was expected to protect the public—and has, for the most part, protected it very well. I proceed to list what seem to me the pertinent ones.⁵

1. Mergers and code-sharing agreements. There is little point in retraversing this particular ground, since most of the damage, to the extent that mergers have done damage, has now been done, irreversibly. As I pointed out to the Committee last year, probably every one of the mergers that have transformed the structure of the industry over the last three years could be said to have offered the promise of either enhancing competition in significant ways, or providing substantial benefits to the traveling public, or both—by conferring economies on the merging parties, by making it possible for them to offer a richer menu of flight schedules, by substituting on-line for inter-line transfers, and so on. At the same time, several have also suppressed direct competition between the merging parties; many more have combined potential competitors; many—probably most—have involved a kind of competition-by-preemption, bringing together carriers in a position either to compete or to feed traffic to one another. In these various ways they have contributed to the domination of hubs by single carriers, and made it much more difficult for other airlines to compete with them except on a correspondingly large scale. These observations clearly apply not just to the recent mergers of trunk carriers but also to the numerous financial consolidations and code-sharing agreements between trunk and commuter airlines.

2. Preferential access to airport facilities. Another factor diminishing the susceptibility of airline markets to competitive incursions is the preferential access that dominant carriers in particular locations enjoy to takeoff and landing slots, gates, and other airport facilities. The causation here doubtless works both ways: the carri-

³Implementation of the Provisions of the Airline Deregulation Act of July 1978, January 31, 1984, p. 14.

⁴Gloria J. Hurdle, et al., "Concentration, Potential Entry, and Performance in the Airline Industry," rev., Washington: Antitrust Division, U.S. Department of Justice, December 1987; Severin Borenstein, "Hubs and High Fares: Airport Dominance and Market Power in the U.S. Airline Industry," Institute of Public Policy Studies, Discussion Paper No. 278, University of Michigan, March 1988.

⁵This discussion draws heavily on the definitive study by Michael E. Levine, "Airline Competition in Deregulated Markets: Theory, Firm Strategy, and Public Policy," *Yale Journal on Regulation*, Volume 4, Number 2, Spring 1987, pp. 393-494. See also Borenstein, "The Competitive Advantage of a Dominant Airline," Institute of Public Policy Studies, Discussion Paper No. 280, University of Michigan, August 1988.

er with the most flights in and out of an airport is likely to have been the one in the best position to help underwrite its original financing by entering long term leases, receiving in exchange preferential access to its facilities; and the carrier enjoying that access is obviously at an advantage compared with actual or prospective competitors. The fact remains that those preferences exist and, I have no doubt, tend to impede competition. Even where scarce slots may now be bought and sold, I find it impossible to doubt that the carrier to which acquisition or retention of slots means the acquisition or protection of a dominant position and monopoly power is going to be willing and able to pay more for them than an airline for whom they represent only a means of initiating or intensifying competition. Conversely, one would suppose, a carrier in possession of those various facilities or rights is going to be less willing to transfer them, for any given consideration, to a carrier that threatens to use them in competition with it than, for example, to exchange them with a carrier in a position to offer it reciprocal advantages elsewhere. Once again, the advantage goes to the large and dominant carriers and the disadvantage to smaller, actual or would-be competitors.

3. Travel agent commissions. Most travelers are probably only dimly aware, if at all, that the travel agencies to which they have found it necessary to turn in increasing proportion for advice and tickets are compensated by the airlines, and that, under deregulation, competition among the airlines for traffic takes the form, in important measure, of offering those agents financial inducements—it would not be inaccurate to characterize them as bribes—to steer travelers their way. The inescapable result is a tension between the incentive of a travel agency to give customers the best possible advice and service—since they compete with one another for the patronage of travelers—and its incentive to take advantage of the most generous offers available from competing airlines.⁶

The resulting effect on the incentives of travel agents is particularly relevant to this Committee's inquiry because of the way in which it tends to reinforce the market position of hub-dominating carriers and to insulate them from competitive challenges. The practice is widespread, I understand, of carriers offering agents override commissions that increase in percentage terms with the number or proportion of travelers delivered to their flights. This kind of compensation has the same effect as progressively increasing quantity discounts or exclusive patronage refunds: it provides a powerful incentive to patronize one supplier exclusively, in order to take full advantage of the higher rewards on incremental sales. The travel agent receiving an average commission of, let us say, 10 percent on the first 1,000 passengers a day delivered to the dominant carrier in its locality but offered a 20 percent commission on the next 100 will obviously have a strong incentive to deliver that next 100 to the same carrier rather than to some smaller competitor, unless the latter matches the 20 percent offer. To look at it from the opposite perspective, the smaller carrier would, in order to compete, have to offer a 20 percent commission on its entire 100 passenger per day business in order to make travel agents indifferent about which airline's tickets to push; the dominant carrier, in contrast, by offering the 20 percent on only the incremental business, ends up paying an average commission of only about 11 percent—10 percent on the first 1,000 and 20 percent on the next 100.

This distorting effect on competition—in particular, its tendency to hamper smaller or new competitors—is apparently reinforced by:

4. Ownership of computerized reservation systems by the dominant carriers, in at least two ways. The first is that ownership of the most widely used CRS in a particular locale by the dominant carrier there is said to provide the latter with a very effective means of pinpointing and monitoring compliance by travel agents with the carrier's various incentive compensation schemes—enabling it to see instantaneously how many tickets a particular agency is selling on its every individual flight, how many on the individual flights of its competitors.

More generally, while the question of whether ownership of CRSs by major carriers today continues to distort competition in the airline business and in particular to impose an unfair handicap on non-CRS-owning carriers remains intensely contested, I believe there can be no doubt that

Ownership has at least in the past been used to bias the displays of flight schedules on the CRS screens and in other ways as well to induce a tendency on the part

⁶ This tension existed even when carriers were required, under regulation, to pay travel agents a uniform percentage commission, because the agent received a larger compensation by selling a more expensive than a less expensive ticket. Elimination of that regulation has, however, introduced an additional distortion of the agent's incentives, and one, as I will explain, that particularly favors the hub-dominating carrier.

of travel agents and customers to select the flights of the CRS owner in preference to its competitors, irrespective of the comparative attractiveness of their offerings;

This "halo effect" is still substantial, whatever the reason, a recent DOT study has found;

According to general opinion in the industry, an airline that does not own a CRS or part of one is indeed subject to substantial competitive handicap—an opinion attested to by the extreme efforts carriers make to obtain such an ownership participation;

There is a very clear tendency for the carriers that bulk largest in the traffic originating at particular hubs also to be the ones whose computerized reservation systems are adopted by the greater number of agents in that locality.

5. Frequent flyer programs. Like most of the other factors on this list, the offer of frequent flyer credits is manifestly a form of competition. At the same time, again like the others, it tends also to distort competition and to strengthen the market position of the larger carriers relative to their smaller competitors, actual and potential, for at least two reasons:

Most flying, and therefore accumulation of these benefits, is probably done by people whose travel is paid for by either clients or the companies for which they work, while the benefits flow to them personally. As in all such situations of third-party payment (the most familiar example is medical insurance), the person who makes the pertinent decisions—in this case, what airlines to patronize—is not subject to the usual economic constraint of weighing convenience and other service benefits on the one side against cost on the other. These travelers will tend therefore to give greater weight to the value of the proffered benefits to them personally than to the price of the ticket, or even to other dimensions of service quality and convenience.

The larger the carrier and the more diversified and rich the menu of its routes on which the frequent flyer credits may be used, the more attractive the credits. This competitive advantage of size and diversity is, just as in the case of the override commissions to travel agents, magnified by the tendency of the credits to grow non-linearly: 50,000 miles on a single airline are typically worth more than 25,000 miles on two separate ones. The result is not only to give travelers a strong incentive to concentrate their travel on a single carrier, but to concentrate it on the one with which they are likely to find themselves in any event doing the greater amount of traveling—i.e., the one that provides the most flights into and out of their locality—and thereby to make those carriers increasingly impregnable against competitive challenge. In this effect it reinforces the hub and spoke system, which likewise confers an advantage on the carrier with the richest schedule of origins and destinations to, from and via the hub.

6. Deep, discriminatory fare reductions in response to competition. I preface my discussion of this factor with an explicit disavowal of any intention to describe it pejoratively. The fact is, however, that the response of the major carriers to price competition in the form of very deeply discounted fares, selectively and discriminatorily offered, has proved to be a devastatingly effective competitive tactic against the principal initiators of price competition in the deregulated airline industry. I think there is no room for doubt that it has played a substantial role in driving most of the new, price-cutting airlines out of the business and in making competitive entry by totally new airlines highly unlikely in the future: the Ultimate Super-Savers, MaxSavers and the like have typically been far lower than the fares that the new competitors were charging on a uniform, single-fare basis, and below their costs as well, even though those costs were typically much lower than those of the incumbents.

Most of those discount fares are unquestionably discriminatory: there is no difference between the costs of carrying a business traveler who is unwilling or unable to meet the condition of staying away over a weekend, but may be equally willing to purchase his or her ticket in advance, and the discretionary traveler, who may travel on the same planes, at the same times, on the same week days, but is willing or able to stay over a weekend. The only difference between these two customers is on the demand side—that is, in what the respective traffics will bear—not on the cost side; and that is the remaining of discrimination.⁷

⁷ True, business travelers as a group generally place a higher premium on frequent service, conveniently scheduled, than do the discretionary travelers on average; and that kind of service is more costly to provide. True, also, both groups of travelers are probably better off because of the price discrimination that levies a disproportionately large part of those enhanced costs on the former, who value that kind of service especially highly. But that is only another way of

Continued

Price discrimination is not necessarily undesirable, however. On the contrary, the ability of the airlines to attract discretionary travelers in this way, and put them in seats many of which otherwise go out empty, has in my judgement been extremely beneficial to the traveling public, making possible consumer savings of billions of dollars a year and the offer of fuller and more convenient scheduling of flight than would otherwise be possible—which has been beneficial to all travelers, including the one being discriminated against.

These fares, therefore, present us with a severe dilemma: they are a form of very effective competition, highly beneficial to the public, so long as they last; they are an efficient, beneficial form of pricing that is unlikely to disappear—although the terms are becoming more onerous and the bargains less dramatic in an increasingly concentrated industry; and yet they have also played a substantial role in producing that increased concentration and weakening competition, both actual and potential.

It is easier to identify the main causes of accumulating monopoly power in the airline industry than to devise remedies that promises to do more good than harm, as is clearly suggested by my ambivalent description of the effects of price discrimination. I can offer no more than a checklist of possible avenues of government intervention, worth exploring, that might correct, mitigate or offset the various concentration-promoting factors I have identified.

I begin with a warning: Although the American economy is largely competitive, and effectively so, market concentration is pervasive, and it often does confer some power—on some suppliers in some markets—to exploit consumers. Competition is always in some degree imperfect, and its effectiveness will vary from one market to another. Small towns, for example, are often not very good places in which to shop for many things; yet we do not for that reason have widespread recourse to regulation in order to protect their residents. The reason is that regulation is likewise highly imperfect, and that was certainly true of airline regulation. If forced to choose between a return to the former regulatory regime and accepting the present one, with all its imperfections, the American people should without hesitation choose the latter.

The pertinent question remains: are there ways in which government intervention short of or quite different from the kind of regulation we abandoned ten years ago might mitigate or counteract the facts I have already identified as promoting monopoly power?

1. Mergers and code-sharing arrangements. It is for the most part too late to close this particular barn door. But the lesson to be drawn from the stubborn refusal of the Department of Transportation—on the basis of an assumption of “perfect contestability” of airline markets that had, and has since, been rebutted by every study of pricing behavior in this industry—to disallow one single airline merger goes well beyond counseling a futile attempt to undo mergers that can no longer be undone. It is that the preservation of competition calls for continuous and vigilant attention on the part of government to all possible suppressions of it, whether by collective or collusive action or by exclusionary practices that deny disadvantaged rivals a fair opportunity to compete on the basis of the quality and price of their offerings. In my opinion, we have not had a sufficient recognition of this responsibility by either the agencies charged with administration of the antitrust laws or the Department of Transportation.⁶

2. Access to airports and airport facilities. I suggest the Committee explore the possibility of eliminating or modifying such preferential access to airport facilities as the present hub-dominant carriers enjoy. Those preferences may well have seemed reasonable compensation for the long-term leases that facilitated the financing of airports; but if they impede competition, they may have to give way, with airports financing construction henceforward on the basis of the economic need for the facilities and the consequent expectation that those costs can be recovered by

recognizing that price discrimination—levying the common costs of providing the same service on different customers on the basis of their respective willingness and ability to pay—may enhance consumer welfare. It remains price discrimination and, as I point out in the text, it may also suppress competition or obstruct competitive entry.

As Levine points out, this discrimination has been an especially effective competitive weapon because the deep discounts enabled the established carriers to take away from the new entrants the very price-sensitive travelers to whom the latter were most likely to appeal, while minimizing the cost of doing so, because the established carriers could continue to charge much higher fares to the convenience-preferring, demand-inelastic passengers, whom it holds also through the offer of frequent flyer credits. *Op. cit.*, pp. 476–478.

⁶ See my testimony before the Senate Subcommittee on Antitrust, Monopolies and Business Rights, Hearing on Airline Deregulation, March 25, 1987.

user charges. The prospective new Denver airport could perhaps provide a useful test case.

At least as important as modifying any such preferential arrangements at existing airports would be expansion of these facilities. In particular, since our principal concern about market domination at the hubs is that it exposes origin and destination traffic at that hub in contrast with connecting traffic there—to exploitation, expanding the capacity of nearby auxiliary airports could provide a greater opportunity for entry of independent carriers competing for exactly that endangered traffic—in the same way that the availability of Love Field, at Dallas/Fort Worth, and Midway, at Chicago, have provided both the opportunity and a protected niche for competitors of the hub-dominating carriers.

3. The compensation of travel agents. I should think at the very least that travelers patronizing travel agencies ought to be provided information, in readily comprehensible form, about the methods by which those agencies are compensated by the several carriers. Competition that takes the form of inducing these intermediaries to steer travelers to one carrier in preference to another cannot but distort airline competition. And if any airlines today pose obstacles to travel agents rebating their commissions to travelers and charging them directly for services rendered, I think that might properly be regarded as an illegal restraint of competition both in the distribution of airline tickets and among airlines.

In making this suggestion, I intend in no way to minimize the importance of the function travel agents perform. Nor do I suggest that deception of their customers is the general rule: competition among them for the patronage of travelers surely gives them a strong incentive to provide honest advice. On the other hand, I cannot see why airlines would offer override commissions or other kinds of special compensation if they did not believe they worked—and “working,” so far as I can see, can only mean giving travelers advice somewhat different from the advice the agent would give if the compensation came exclusively from the traveler.

4. Prohibition of airline ownership of computerized reservation systems. I continue to believe, as I have testified on two previous occasions,⁹ that separation of the provision of CRSs from the operation of airlines would probably serve to eliminate such handicaps as the present system imposes on non-CRS-owning competitors and weaken the link that now ties together the interest of the travel agent with that of the carrier dominating traffic in and out of a particular locality.

Short of divestiture, there are other regulatory requirements worth exploring that might, by weakening the intimacy of the alliance between the CRS owner and travel agent, make competition more effective. One would be to limit the length of the contract. Another would be to limit the liquidated damages that the owner is entitled to collect from an agent who terminates the contract to the recovery of costs incurred in the past, rather than, as I understand to be the case today, the recovery of lost future revenues.

Another—justified, I suggest, as a consumer protection—would be a requirement that all CRSs be programmed to give the traveler who asks for it the lowest available fare between any two points regardless of the routing. Yet another would be to require open disclosure of a carrier's actual average yields on each route. It is an elementary proposition that competition works best when consumers are fully informed. While I can see that it would probably be impractical for a carrier to have to disclose in advance what percentage of its seats on each flight are available at the lowest publicized discount fare, or to require it to make some minimum percentage available, as has been recommended, I do not see why actual yields (which would automatically reflect the proportions of sales at different fares) need be regarded as proprietary information: if carriers can usefully be required to report on-time performance, why not also price?

5. Frequent flyer programs. For the traveler who pays his or her fare, frequent flyer benefits are, in effect, a quantity discount; and while they favor the larger carrier in competition with the smaller one, I do not see what the government could possibly do about them, or should.

In contrast, the frequent flyer credits earned by travelers whose fares are paid by their employers, and therefore deducted from taxable income by the latter as a business expense, are a form of income; and, it seems to me an unquestionable proposition, they ought to be subject to income tax. Administration of such a tax—differentiating the two categories of credits that I have just described and placing a fair valuation on the credits—would not be simple. On the other hand, there are two

⁹ House Subcommittee on Aviation, on Competitive Problems Raised by Computerized Reservation Systems, June 22, 1983, and Senate Subcommittee on Aviation on Computerized Reservation Systems, March 19, 1985.

good reasons for Congress to try. One is the obvious fiscal reason—the budget deficit and the unfairness of these benefits escaping taxation. The other is that it is the credits extended to the business traveler, above all, that are most likely to distort and thereby ultimately to suppress competition, because they dispose him or her regularly to patronize the biggest carrier serving his or her community, regardless of the presence of competitive alternatives.

6. Targeted, deep discriminatory price reductions. As I have already observed, there is no simple formula for deciding which of these competitive price reductions is on balance undeniably competitive and which not. It is also entirely possible that government intervention attempting in one way or another to protect competitors from this kind of pressure may do more harm, by discouraging price competition, than it does good, by protecting competitors from predation.

At the same time, I think it undeniable that this particular method of competing in price has played a major role in reconcentrating the airline industry. And I urge the Committee to reject the simplistic argument, made by many economists, that predatory price cutting—intended specifically to discipline, eliminate, or discourage the entry of troublesome competitors, in expectation of being able to raise prices afterward—is unlikely to occur because it is likely to cost the large predator more than the victim and, so long as entry into the market is free, the predator is unlikely ever to be able to reap the rewards in monopoly prices.

Ten years ago, on the eve of the CAB's decision to admit all fit, willing and able applicants into the transcontinental market, I wrote to my fellow Board members expressing the opinion that we ought to be thinking in advance of possible ways of limiting the competitive response of the incumbent carriers to the entry of World and Capitol Airways, with proposed one-way fares of \$99, at a time when the regular round-trip coach ticket between New York and Los Angeles was \$430 (which is equivalent to more than \$775 of 1988 purchasing power). I expressed the fear that, in the absence of any such limitation, the incumbents would, by quickly matching the \$99 fare, soon drive the intruders out of the business, and the price then return to its previous level. If that happened, I said, I have no confidence that we might quickly expect another such challenge, with the lesson of a World and a Capitol driven from the market fresh in the minds of potential entrants.¹⁰

The experience of the last 10 years, I submit, has in important measure corroborated that expectation—even though, I repeat, it is a fair evidence of the increased competitiveness of the industry since deregulation that almost certainly only a very small percentage of transcontinental travelers today are paying anything like the \$775 equivalent to the 1978 coach fare.

I have no simple resolution of this dilemma to recommend. I suggest, however, that an antitrust enforcement agency that was not a slave to the deductive logic that has led so many economists and judges in effect to say that predation doesn't make sense and therefore does not exist ("I think; therefore it is not"—an interesting variant of Descartes' "I think; therefore I am"), an agency aware not just of the danger of confusing the protection of competitors with the preservation of competition but also of the fact that without competitors there is no competition—that such an agency would have taken the trouble in at least some of these instances to consider whether on balance the price cuts would be likely to destroy competition. At the very least, it might have investigated to what extent the deeply discounted fares were specifically targeted at competitive entrants, in what relative numbers and proportions they were made available on competitive and non-competitive routes, to what extent they were obviously intended to be temporary, contingent on the disappearance of the competitors, or to what extent they have in fact proven to be.

People, like me, who express concern about the possibility of predation are sometimes accused of favoring "soft" over "hard" competition. Ultimate SuperSavers of \$258 for a round trip between New York and Los Angeles, such as are still available in September of 1988, do indeed reflect the "hard" competition that continues to prevail for one-stop, transcontinental traffic over a large variety of hubs. On the other hand, the lowest unrestricted roundtrip fare on that route today, my travel agent tells me, is either \$900, \$1,100, or \$1,120: that looks rather "soft," compared with the unrestricted fares that used to be available on the now-defunct World, Capitol, and People Express. So, too, does USAir's present unrestricted one-way fare of \$99 or \$131 (my travel agent doesn't understand why there are two) between Buffalo and New York City, as compared with the \$45 to \$54 on peak and \$29 to \$39 off

¹⁰ "Towards a Policy for Dealing with Competitive Responses," memo to the Board, October 19, 1978, partially reproduced in my "Deregulatory Schizophrenia," *California Law Review*, May 1987, pp. 1066-1067.

peak available to all passengers on both USAir and People Express three years after the latter's entry into that market, while it was still operating.¹¹

7. Foreign competition. The only carriers likely to be able to challenge the ones now dominating hubs will be other large carriers, with a similarly broad range of operations, able to extend service to that hub from hubs of their own. In the present state of the industry, that is likely to be only one of the six other major domestic carriers; and they are less and less likely to challenge one another across the board at their respective hubs.

There are other potential challengers, however—foreign carriers, looking for U.S. domestic feed for their international operations, especially if they were permitted also to fill out their flight schedules and planes by carrying domestic traffic as well.

But that is legally prohibited today. Foreigners own hotels, banks, real estate, and a wide variety of manufacturing plants in the United States; but they cannot own more than 25 percent of an American airline or carry domestic U.S. traffic. I urge the Committee to consider seriously legislation that would relax the former of these restriction, at least in situations in which a closer affiliation between a foreign and domestic carrier would invigorate competition. This could well be the case, for example, if a foreign airline, seeking reciprocal feed to and from its international flights, were to join with a new domestic carrier or a struggling commuter or regional airline that would otherwise have no choice but to link up with a domestic trunk already dominating the hub it serves or seeks to serve. I see no reason why we should systematically deny travelers at those hubs the benefit of this potential competition.

The notion of admitting foreign competitors more freely into our domestic market is not likely to be very attractive politically, in these days of concern about the deficit in our balance of trade and foreign barriers against our goods and services. For this reason I see no point in suggesting elimination of our present flat prohibition of cabotage—carriage of domestic traffic by foreign airlines. Consistently with the spirit of the new trade law, however, an American administration sensitive to the values of competition to American consumers might well aggressively pursue negotiations looking to freer trading opportunities in aviation on a genuinely reciprocal basis, taking into account both the formal and pervasive informal barriers that now exist. The emergence of a truly free European Common Market in 1992 could well provide an opportunity for such a bargain, which would involve giving American carriers freer access to that market of 390 million people in exchange for freer access of foreign carriers to the carriage of American travelers.

The established American carriers may respond that they have all the international market opportunities they require; but that is not the pertinent question. The pertinent question is whether American—and European—consumers have all the protections of competition that they require.

8. Price ceilings. I include the possible reimposition of price ceilings on my list not because I recommend them—I do not—but because they will in any event inevitably occur to the Committee as an apparently simple and logical remedy, and because I feel it important for you to understand the very large problems and dangers it would raise.

As I said to this Committee last year, I cannot in principle exclude this method of restraining the exercise of monopoly power, if it turns out there are markets in which competition is intolerably inadequate to protect consumers.

I can only vaguely suggest at this point, however, the problems any such intervention would encounter, but they would clearly be formidable. The routes on which one carrier or another may enjoy excessive monopoly power are inextricable parts of comprehensive, intricate and ever-changing route systems; the costs and revenues of each part are combined and interrelated with the costs and revenues of all the others, in complicated and constantly changing ways. It is difficult to envision ceilings set on any basis other than cost; but the particular services—to particular groups of customers on particular routes—in the provision of which the carrier may be exploiting its monopoly power will be joint or common products produced in combination with an enormous variety of other trips, or same trips but for other customers; and I suspect there is no non-arbitrary way of determining their separate costs.

Moreover, price ceilings will tend inevitably to have deleterious effects on the frequency of service. Since frequency is the most important dimension of service quality for the non-discretionary traveler—the very ones most likely to be exploited by

¹¹ By an interesting coincidence, USAir's unrestricted fare was \$99 *before* People Express entered that market, in 1981. See my "The Macroeconomic Consequences of Sensible Microeconomic Policies," White Plains: National Economic Research Associates, 1985, pp. 13-14.

high unrestricted coach fares, because their demand is the least elastic—the net effect could well be to leave worse off than before the consumers whom it is the purpose of fare ceilings to protect.

And that in turn would probably diminish the availability of bargain fares as well. The reason is that how densely it pays an airline to schedule flights will depend, disproportionately, on how much it is able to charge the full-fare-paying customers; that much is obvious. What is perhaps less obvious is that the more frequent the flights scheduled, primarily to meet the needs of those, mainly business travelers, the greater also the availability of discount tickets, to fill with discretionary, price-sensitive customers seats that would otherwise be unoccupied. So the customers who most require frequent service, which is costly to provide, pay the correspondingly higher fares; and the discretionary travelers, who enjoy the resultant bargains, nevertheless also help make that service frequency possible.

I suspect I am more than most economists sensitive to the presence of monopoly and eager to do something about it. But partial regulation—if only of fares and only certain fares—is, I fear, likely to do more mischief than good; and full-fledged reregulation would, I am convinced, be a catastrophe for the overwhelming majority of consumers.

I regret that I have not been able to offer the Committee a simple set of prescriptions for combatting the problems of hub domination. I have an excuse: there are no simple solutions. Every one of the possible courses of action I have suggested has its difficulties, political or economic; every one has its costs as well as promised benefits.

But that is the nature of the problem of devising sensible economic policies. If there were simple solutions—whether to problems of unfair or discriminatory international trade practices, acid rain, effectively regulating public utilities, or preserving effective competition—we would long ago have found them. All policies and all markets are imperfect. The question in each case is whether the imperfections are so severe that remedial action, even if inevitably imperfect, is likely to produce a better result.

In my opinion—and that, I believe, of the great majority of disinterested observers—airline deregulation was such a change: its results are on balance a very great improvement over the results produced by the previous regulatory regime. If the Committee now finds that the problem of hub domination and monopolistic exploitation of certain classes of travelers are severe enough, most of the courses of action that I have suggested might produce a net improvement, but full-fledged reregulation, I am certain, would not.

QUESTIONS OF THE CHAIRMAN AND THE ANSWERS THERETO

MEDIUM-SIZED CITIES

Question 1. Dr. Kahn, based on your experience with airline service and fares under deregulation, doesn't it seem that many of the nation's small and medium-sized cities have experienced unjustified fare increases?

Answer 1. Yes, it does seem that travelers in and out of many small- and medium-sized cities who buy coach or regular tourist tickets are now paying fares higher than they would have paid under continued CAB regulation. But this is only an impression, and must be qualified immediately in the following ways:

a. Congress should not make policy on the basis of what "seems" to have happened. The first need is for facts.

b. The CAB's price-setting formulas attempted explicitly to subsidize service to small cities, particularly on short hops, at the expense of longer hops and denser routes. Since I see no reason for such subsidies—apart from the essential Air Services Program—I have no way of knowing whether such increases as have occurred are economically unjustified.

c. The fares that seem to be above CAB levels are apparently for only the small minority of travelers who pay full coach. I can get SuperSavers and other very good discount fares in and out of my home town of Ithaca, New York, with a total metropolitan area of only 60,000 people. According to the Airport Transport Association, over 90 percent of travelers last year traveled on discount tickets, with an average discount of 62 percent. Moreover, as a general proposition, it is the people who pay coach fares—primarily business travelers—who benefit from improved convenience of scheduling, on average, in and out of small- and medium-sized towns, as well as frequent flyer benefits. That kind of convenient scheduling is expensive to provide,

and I have absolutely no basis for concluding that, to the extent regular coach fares are much higher than before, they are an excessive price to pay for it.

d. It seems to me, therefore, that the very first step must be for Congress to require that we get better information than we have now about what has happened to average fares in and out of small- and medium-sized cities, full coach fares, separately, and the percentage of travelers paying the full coach price. Then we can proceed, perhaps, to make an intelligent decision about whether the latter has been subjected to extortionate pricing.

FARE REGULATION

Question 2. You have stated several times that, during the debate on deregulation legislation, you argued that carriers operating monopoly routes should not be allowed unlimited fare increases. Today, we have that happening in many markets. Now that time has proven you right, as fares are rapidly increasing, what should we do to protect consumers?

Answer 2. I have two answers to this question. The first, as I've already pointed out in answering the first question, is that I simply do not know whether "time has proven (me) right," and, if so, to what extent it has done so. We need the facts. Consider, for example, the recent GAO report observing that prices have increased more in and out of St. Louis than in the country generally, by about 10 percentage points, since the TWA-Ozark merger. I have no reason to doubt the correctness of this finding. But it doesn't begin to tell me whether average prices on those routes are extortionately high. Consider one obviously pertinent question; is TWA making monopoly profits?

My second answer is that the proposal to retain ceiling prices during the 1977-78 period was made in the context of an expectation that CAB regulation would not be totally dismantled. What we were contemplating at that time was simply offering the carriers greater freedom of entry, on the one side, and a wider range of pricing flexibility, on the other. Now that the entire structure of regulation has been eliminated, it seems to me the task of trying to set ceilings on particular fares to particular, limited categories of customers, on particular routes that are part of a system-wide network, is an almost impossibly difficult task. What I suggest is that Congress either assemble a group of airline people to discuss the feasibility of such a limited re-regulation in very concrete terms: we have to have some sense of whether it is even possible to do so in a rational way, and to take into account, as I did in my testimony, the possibly adverse effect of such ceilings on the frequency of scheduling, which may in the end leave the very travelers who are paying the high fares worse off than before.

Question 3. You claim that we cannot make a partial return to fare regulation without creating distortions—such as the loss of discount fares. If that option is not appealing, what would we do to correct the equity problems created by deregulation?

Answer 3. I have tried in my testimony to list all the steps I could think of that offer some promise of making the industry more competitive than it is now. I can't think of any others.

Question 4. What are your views on the possible imposition of a mileage-based fare structure? Wouldn't this alleviate the problem of short-haul flights now subsidizing long-haul flights?

Answer 4. First of all, it is by no means clear to me that "short-haul flights (are) now subsidizing long-haul flights." For one thing, the price structure imposed by the CAB did the reverse. I refer you also to my testimony before your subcommittee in November 1977 for my refutation of this cross-subsidy argument. Requirement of a mileage-based fare structure would in effect constitute total re-regulation; the first thing it would do would be to eliminate the deeply discounted fares that are saving travelers many, many billions of dollars a year, and are logically offered only on the basis of the availability of seats that would otherwise go out empty. There is no way of relating that sensible development to mileage; and it is by no means clear that if discount fares were eliminated other fares would go down.

DISCOUNT FARES

Question 5. You stated that discount fares are becoming less dramatic, but that, regardless of the fact that the airline industry is becoming more concentrated, these reduced fares are not likely to disappear. Given the existing barriers to entry, why should we expect discounts to continue?

Answer 5. The reason is the same as the reason public utility industries charge lower rates off peak than on peak; it pays even a monopolist to offer discounts, as

deep as necessary, to attract customers who would not otherwise buy its services, to make use of capacity that would otherwise be excessive.

AIRLINE INDUSTRY FUTURE

Question 6. There is a possible scenario that in the coming months the airline industry could be shaken by the bankruptcy—or significant downsizing—of 2-3 carriers. If this were to occur, what would you suggest be done? Would that be a time where we would have to consider re-regulation in order to ensure the continuation of basic, affordable air service?

Answer 6. This question gives me the opportunity to assert that in rejecting all suggestions for effective re-regulation of the airlines, I am far from regarding myself as an ideological, die-hard proponent of laissez faire. When and if it appears that deregulation has been a failure—and I have set forth reasons for my firm belief that it has, on the contrary, been a smashing success on balance—I in no way exclude the possibility of saying something like: "Well, it certainly brought major benefits to the American traveling public, on balance, in its first ten, twelve, fifteen or twenty years, but it has not gotten to the point where the evils of monopoly outweigh the benefits of dissolving the CAB's pervasive restraints on competition, and it is time to re-regulate."

What I assert with total conviction right now is that the record simply does not justify such an overall assessment, and therefore what we have to look for very hard is, first, some sense of how important and severe the *exceptions* to the overall success have been, and, depending on what we find, what can be done about it. The various suggestions that I have offered are all entirely compatible with deregulation, and are aimed at trying to strengthen entirely compatible with deregulation, and are aimed at trying to strengthen the protections of competition. If they don't work, and if it becomes clearer that things have gotten bad enough, then is the time to consider comprehensive re-regulation.

Senator Ford [presiding]. Thank you, Mr. Kahn.

There has been a flurry of activity behind the chairs here, and I might explain that to the audience. There has been an objection lodged on the Senate floor. Any committees meeting after the normal hour, two hours after we came in, and that was 11 o'clock. So, you may be giving your testimony and we will have to have it expunged. But it is like telling the jury not to think about that anymore.

So, it may be that we will have to—I looked at the last four witnesses, and they are all from Washington, DC with the exception of one and that is Richard Judy from Miami, Florida. I don't know what we will be able to do. But we shall proceed.

Senator Danforth.

Senator DANFORTH. Mr. Chairman, thank you very much. We are working on this problem and if we can't solve it, maybe instead of calling this testimony, we can call it a banana.

Mr. KAHN. What a way to go down in history.

Senator FORD. Well, you will be peeled.

Senator DANFORTH. Mr. Mead, do you have any doubts that the concentration at Lambert has led to increased fares?

Mr. MEAD. No, Mr. Danforth, we have no doubt. We cannot quantify exactly what percentage of the increase in fares is allocable to the merger. We think it is interesting that Secretary Burnley's own results at two other hubs suggested quite comparable results involving other airlines.

Senator DANFORTH. Mr. Kahn, do you have any doubt that the concentration at Lambert has led to increased fares?

Mr. KAHN. I haven't studied it myself, but I don't have any reason to doubt the evidence.

Senator DANFORTH. You don't have an opinion one way or another?

Mr. KAHN. The evidence I have seen shows that hub domination does lead to higher fares.

Senator DANFORTH. Does lead to higher fares.

Mr. KAHN. For O and D traffic particularly.

Senator DANFORTH. For what?

Mr. KAHN. That is for traffic, not people who are flying over the hub and transferring to another flight because they usually have about 10 other hubs, but the people who live there.

Senator DANFORTH. Sure.

And as a matter of general economic principle, it would follow, wouldn't it, that if one airline has, say, 82 percent of the traffic at an airport, then the fares would tend to go up?

Mr. KAHN. You certainly would expect that, Mr. Chairman.

Senator DANFORTH. And your view is that we should not re-regulate the airlines and further that even contingent regulation—that is, regulation that is triggered by a certain percentage of transportation or dominance at an airport—is something that we should avoid.

Mr. KAHN. Well, it is such a serious and complicated subject that I would hate to see us do anything without having a session exclusively on what kind of problems it would raise. And the more I thought about it, the more almost hopeless it seemed to me. How do you determine the costs of a part of a trip for a part of the passengers? Because remember, at the dominated hubs, you have a tremendous number of discount fares available to discretionary travelers whose demand is very responsive. So, it is a small percentage of the travelers who pay these fares that are unquestionably monopolistically high in my opinion.

Senator DANFORTH. Do you have an opinion on that, Mr. Mead?

Mr. MEAD. Yes. The elimination of Ozark at Lambert Field increased TWA's share of passenger enplanements, as you pointed out, to 82 percent. I think it is common sense that if you tell me that I am in the business of selling widgets, and I'm free to sell widgets without competition or the threat of meaningful competition, that I will charge you what I can for my widgets.

Senator DANFORTH. What I am asking is—maybe you don't have an opinion on whether re-regulation is the—

Mr. MEAD. Oh, I'm sorry. I would agree with Mr. Kahn that that is something that we would look to after all other avenues were exhausted.

Senator DANFORTH. So, really the goal should be to expand competition rather than to re-regulate.

Mr. MEAD. Exactly.

Senator DANFORTH. Do we have a consensus between the two of you about what is necessary to expand competition? Both of you have mentioned several barriers that now exist to competition. I take it that there is a general agreement.

Mr. KAHN. I think certainly as I listened to Mr. Mead—

Senator DANFORTH. Expanding airport capacity would be part of it. Right?

Mr. KAHN. Certainly.

Mr. MEAD. Yes.

Senator DANFORTH. The CRS problem, the frequent flyer problem, the fact that there is a financial benefit for travel agents steering people towards particular airlines on the basis of value of tickets sold per airline, all those would enter into the competition?

Mr. MEAD. All those factors would enter into the competition. I think from GAO's point of view, we are prepared to say that it is time for government intervention on the CRS issue.

On the other barriers to entry, I think we would wish to reserve judgment until further facts were in as to exactly what needed to be done.

Mr. KAHN. After all, I have tenure at Cornell. I can speak more freely.

Mr. MULVEY. We do have ongoing work in that area, however. We have ongoing work in the area of other barriers to entry which we hope to be completing early next year.

Senator DANFORTH. This is part of the broader study?

Mr. MULVEY. Right.

Senator DANFORTH. When will that be completed?

Mr. NOEL. The barriers work will probably be completed within the next 9 to 12 months. The shorter look at what is happening at the other hubs to fares and service there will probably take about six months. These are our current projections.

Senator DANFORTH. Should we wait another year, Mr. Kahn, before we address it?

Mr. KAHN. I think there are certain things you can do now. I think that we are getting a consensus on CRS. There are variety of alternative approaches of which divestiture is only one. There are others. Certainly setting ceilings is something that I would wait a long time on.

Mr. MEAD. Senator Danforth, if I might give somewhat of an exposition on why it is urgent that computer reservation services receive attention.

In the St. Louis market alone, Trans World owns a computer reservation service called PARS. They have 77 percent of the CRS market there. The average booking fee charged by CRS' owner is about \$1.84, and the average profit nationally per enplaned passenger has ranged from \$1.00 to \$2.00. So, as you can see, the arithmetic is such that a new airline whose seats are booked through the vast majority of travel agents in the St. Louis market, will pay a booking fee that would exceed the possible profit that it might obtain from carrying passengers.

I don't mean to limit that observation to Trans World. They have a very minor system in the scheme of computer reservation systems.

Senator DANFORTH. Thank you, Mr. Chairman.

Senator FORD. Senator Kassebaum?

Senator KASSEBAUM. Thank you, Mr. Chairman.

Mr. Kahn, you are really somewhat the godfather of deregulation, and so your comments on what has happened and what we should do, of course, are taken quite seriously.

I am interested that both you and Mr. Mead seem to agree that perhaps DOT should step in with regards to the CRS, that these systems should be required, I think you said, to show the lowest available fares. Is that right?

Mr. KAHN. Yes.

Senator KASSEBAUM. We have held some hearings, of course, over the past several years on this. And it has been very frustrating trying to get at the real cause of CRS problems and to decide what could be done regarding CRS.

Now, PARS, as you mentioned, is not, of course, as significant as two of the other systems, and PARS recently has been partially purchased by Northwest Republic. Is that correct?

Mr. KAHN. Yes, I think it is 50/50.

Senator KASSEBAUM. Has that made any difference? Does PARS tilt now to both TWA and Northwest Republic? Have you looked at whether this has made any difference in what is actually shown on a PARS screen?

Mr. MEAD. Oh, no. I think we should clarify one thing. Secretary Burnley was focusing on the display bias rules.

Senator KASSEBAUM. Right.

Mr. MEAD. In our testimony today, we were not suggesting that there is a display bias of the type that is prohibited by the rules. We haven't found evidence of that. I think what Mr. Kahn is referring to is simply that the order of flights be—that the cheaper flight be put first, and that seems reasonable.

Senator KASSEBAUM. Isn't that a display bias?

Mr. MEAD. Yes, it is, but what they were doing before is the owning airline's flights would show up first on the screen.

Senator KASSEBAUM. Right.

Mr. MEAD. And naturally the travel agent would tend to pick that one.

Senator KASSEBAUM. So, you don't necessarily think there is a display bias.

Mr. MEAD. Not a display bias, but it is clear, even the DOT study which was issued in May of this year I believe, concludes that the airlines who own these CRSs are receiving between 12 and 40 percent additional revenues that they would not otherwise have gotten but for the mutually supportive business relationships they have with the airlines.

Senator KASSEBAUM. Of course, you can make the argument that they haven't done this necessarily out of goodwill for the industry as a whole. I mean, they have put a lot of money into the development of their system, and I am sure that they want the returns from that. It seems to me if we are going to make certain requirements that will be fair and equitable to the system as a whole, perhaps we have to then think of the impact of any new requirements on the system owners.

Mr. MEAD. One of the bigger problems that I see with divestiture where you have common industry ownership of the system is how you decide how to compensate the investment of, say, United and American that currently have a 75 percent market share.

Mr. KAHN. Senator Kassebaum, the DOT study itself shows us that they are being compensated to the extent of many billions of dollars a year right now. That is number one.

Senator KASSEBAUM. That's true.

Mr. KAHN. Number two, of course, anybody who is interested in competition has to be sensitive to not interfering with the incentives of innovators to reap the rewards of their innovation. But

there is also a very familiar antitrust doctrine that where they have achieved their market position not simply because of their innovation, but because of their previous domination as carriers—it would tax credulity to believe that American Airlines did the perfect innovation for Dallas/Ft. Worth, so they have 91 percent there, but United Airlines did the perfect innovation for Denver, so they have 76 percent there. So, it is obvious that this is a consequence also of their dominant position as airlines.

And where that is demonstrably interfering with competition or distorting it, I think we do have an obligation to try to balance—reach a balanced—not an expropriation, but a balanced solution which eliminates that preferential arrangement.

Senator KASSEBAUM. I certainly agree with you.

One of my biggest disappointments in deregulation is that we have not seen the development of the smaller airlines, the commuter airlines, to the competitive strength that I think many had hoped for. Do you have any suggestions, either you or Mr. Mead or anyone else, about this problem?

Mr. NOEL. Senator Kassebaum, I think that the code-sharing arrangements between commuter airlines and the majors, which benefit financially both the commuter and the major airline, by providing a predictable amount of feed traffic, have foreclosed entry into the commuter industry simply because a newcomer can't compete on those thin routes. The commuters have been, and you can look at some of the new entrants after deregulation, like farm clubs, that would supply new firms and provide regional competition. That farm club has been basically dried up by vertical integration in the industry.

Senator KASSEBAUM. I know. That is why I am wondering if you see this as a problem, and if anyone had any suggestions.

Mr. KAHN. I am sure it is a problem. I agree totally with Mr. Noel. Originally the commuters were a source of potential competition. And while they weren't commuters, Allegheny and Piedmont, sort of previously local service carriers, demonstrated that potential. Instead of turning travelers over dutifully to the trunks, they said, well, they are going to get into the business using relatively small aircraft so they could have convenient scheduling. And the commuter part of the business has grown enormously in volume.

But I am afraid that because of these vertical arrangements, we no longer have that source of potential competition. You are scarcely in the commuter business today unless you are really, in effect, part of the major trunk system with the same code number.

Now, that has great advantages, and that is one of our problems. Many of these things we are describing have great advantages as well in terms of ensuring a certain common level of maintenance, of service. USAir or Allegheny keeps very close scrutiny over Allegheny Commuter, and I am sure American does with American Eagle and so on.

I toyed for a while with the notion of saying, well, if you control a bottleneck, 80 percent of the traffic in and out of a hub, which is essential for anybody to survive—any commuter can't be in business unless it interlines with you—maybe we should require that you do it on a nondiscriminatory basis with all comers. After all,

that is the essence of the antitrust decree in the Bell case. If you control the bottleneck, you can't just offer it to one competitor.

I don't think, however, that will hit the problem of hub domination because all it means is that two commuters will then be tied up with the hub dominant firm. But I think it is still worth considering from the point of view of independent entry into the commuter business.

Senator KASSEBAUM. And I would argue that the lack of competitive service to points out in the spokes has been a real problem.

Mr. KAHN. Exactly.

Mr. MEAD. Yes.

Senator KASSEBAUM. I have another question.

Senator FORD. Go right ahead. You may have my time.

Senator KASSEBAUM. My time is up.

Senator FORD. My time is your time.

Senator KASSEBAUM. Mr. Kahn, talking about mergers, you had made a comment in a recent interview that you felt that the USAir-Piedmont merger should not have been approved. I share your general observation about mergers happening too rapidly, but that to me was an example of a merger of two healthy airlines that made some good business sense to merge and which were otherwise subject to hostile takeover by other major airlines.

What were your reasons for thinking this was not a wise one?

Mr. KAHN. First of all, because I have the laboratory experiment. I live in Ithaca, New York, which is served by two airlines, Piedmont and USAir. But if I want to go to Syracuse to fly to New York, as I often do, there are two airlines that provide that service: USAir and Piedmont. If you want to fly from Syracuse to Boston or from Buffalo to Boston or—not Buffalo—Rochester to Boston, again only two airlines: USAir and Piedmont.

The reason Secretary Burnley is able to say that there was no opposition to the USAir-Piedmont merger, other than America West—one reason is that I was asked by the attorneys general of New York, Massachusetts and West Virginia if I would help them oppose the merger. And after looking at it a while and reading the decisions of the Department of Transportation in previous cases, I said it is hopeless. There is no point. You may as well get the best deal that you can from them, and that is what they did.

They were both healthy airlines. I don't think government policy would have permitted them or should have permitted them to be acquired by another domestic carrier.

I think there is a point beyond which, even though plausible arguments can be made for all these mergers—none of them is a clear-cut case—there is a certain point beyond which you say if there is a substantial amount of horizontal competition, I'm sorry, no.

And the various merger guidelines of the Department of Justice would clearly have outlawed many of these mergers. But that is water over the dam.

Senator KASSEBAUM. I was just interested in hearing your observation.

Mr. KAHN. That was my reason.

Mr. MEAD. Senator, in this particular case the Department of Transportation's administrative law judge disapproved the merger.

But, his recommendation was subsequently rejected by the Secretary.

Mr. KAHN. Yes. It almost made me look wrong in my prediction, but I did a TV commentary in which I praised Judge Yoder, and I said but don't count your blessings. It hasn't gone to DOT yet.

Senator KASSEBAUM. Well, I think perhaps more than anything, that merger shows that it has been difficult to formulate clear guidelines that if they prevailed in one merger, should prevail in all. That is difficult to do, and perhaps, as Secretary Burnley said, it should have gone to the Department of Justice in the first place. It is water over the dam, as you say. And now we have to go on to see if there are some things that we can do. Perhaps the CRS problem is an example.

Mr. KAHN. Senator Kassebaum, on the merger question, I alluded—and I think I am the only one who did—in my testimony to the possibility that a foreign airline—I know foreign airlines were negotiating with Air Atlanta, which has now disappeared. There are foreign airlines that are worried about feed that they are losing. I recognize the need for reciprocity here, but at the same time you might get mergers there, acquisition of a failing domestic carrier. And the only people who might be able to compete with the hub dominant carriers might be a foreign airline. They would hire Americans. They would be working in the United States, but they might have a commonality of interest that might give you a merger that would invigorate competition.

Senator KASSEBAUM. I very clearly heard your comment, Mr. Kahn, and I can only assume a lot of red flags went up when you said what you did.

Mr. KAHN. I never doubt that you hear anything that anybody says, Senator Kassebaum.

Senator KASSEBAUM. I think that is a very good observation.

And as I pointed out, two days ago we had a very important markup session here regarding dominance, market dominance in the railroads. I think we need continual review.

Thank you very much.

Senator FORD. Thank you very much, Senator Kassebaum.

I have no questions. I will make an observation. Deregulation was to give us competition. Now we are trying to figure out how to eliminate the dominance that resulted. That is like saying we're going to divide everything up on Monday morning and everybody has an equal share. Come Saturday night, the smart ones or the rich ones are going to have it all. You say, oh, yes. Then on Monday morning we are going to divide it up again.

So, it gets a little bit touchy I think when we begin to look at business itself and how we allow business to go after the industry and the consumer of that industry and we try to figure out some way to stop them from making so much money and divide it up again. It bothers me some, Mr. Kahn.

Mr. KAHN. Well, Senator Ford, the one thing I think the committee must bear in mind Secretary Burnley is totally correct when—

Senator FORD. Not all the time.

Mr. KAHN [continuing]. When he says that the airline industry today is unquestionably far more competitive than it was under regulation. There is just no room for doubt about that.

And the airline industry is not making piles of money. They are having a good year this year, and that is fine. They couldn't survive if they would continue to have years like 1986. But I don't think there is any room for doubt.

There are problems. What American industry doesn't have problems?

Senator FORD. And government ought to stay out of it and quit trying to solve it for them. If we would stay out of their business, they might be a hell of a lot better off too.

Mr. KAHN. Well, that is, of course, what we tried to do 10 years ago in the airline industry.

Senator FORD. So, now we are trying to get back in again and say that they have an innovative idea and they have a corner of in the market, and that is a no-no, so we have to divide it up among the rest of them.

Now, I don't know what they do to your department even though you have tenure. If they walk in there and say we are going to take tenure away from you because we can hire two for the price of one you're gone. Something about it just doesn't sit right in the pit of my stomach. Maybe we can work it out.

But it does bother me considerably what it appears we are trying to do here. The word "re-regulation" has come back into view, and we don't want to do that, but yet we are trying to figure out somewhere in between regulation and deregulation, and that is hard to do.

Mr. Mead, are you about ready to take issue?

Mr. MEAD. I think it is an insightful set of observations you are making.

The type of regulation that we are speaking of today is different from fare regulation, and it is different from route regulation. Over the years, since deregulation, barriers to entry have arisen, some of which were not foreseen a decade ago.

These barriers give some airlines an artificial competitive advantage. I believe our goal over the next two or three years is to be to reduce or eliminate these artificial competitive advantages. But the regulation that might be needed has very little to do with fare and route regulation.

Senator FORD. Yes, but every time you promulgate regulations, you are going to re-regulation. Anytime you put a new regulation on the industry, you are beginning to re-regulate again. And, of course, what I would like to see—and some of the problems could be worked out if we could get the airport trust fund off budget so we can go ahead and spend it because the increased traveler is paying an 8 percent tax, and we keep building it up to hold the deficit down. If we take all the trust funds off budget, we would find out how really bad off we are. But we would start spending the money that we are taxing the increased numbers of travelers flying in those airplanes.

I am just talking out loud. I'm through.

Do you have anything else?

Senator DANFORTH. No, I don't, Mr. Chairman.

Senator FORD. Thank you, gentlemen. You have been very good today.

We have to be out of here by 12:30. So, I am going to ask panel 1 and panel two, Mr. Landry, Mr. Cozzi, Mr. Dunham and Mr. Judy, to come forward.

We are going to move first to Mr. Judy. We will start with Mr. Judy and then Mr. Dunham. Go right ahead, Mr. Judy.

STATEMENT OF RICHARD H. JUDY, DIRECTOR, DEPARTMENT OF AVIATION, MIAMI INTERNATIONAL AIRPORT

Mr. JUDY. We have already submitted our written testimony which we request—

Senator FORD. I might advise all of you. Most I think have submitted your testimony. It has been read by Senators and staff. In order to expedite it so we might get to questions, I would hope you would highlight your statement. All of them will be included in the record.

Okay, Mr. Judy.

Mr. JUDY. We have already submitted our testimony which we request be entered in the record, and would like to spend our time this morning drawing an analogy which we believe helps explain why airline concentration is increasing, how it has been accomplished, and most importantly, what needs to be done. Please understand that we cannot possibly hope to cover the great range of relevant issues covered in our written testimony in the five minutes we have this morning.

Lastly, before I delve into the analogy, we wish to make it absolutely clear that the blame for the present state of competition in air transportation does not lie at the feet of the airlines or airport operators. Airlines have behaved exactly as they should in the free market. Instead, the blame rests on those—and that does not mean airport operators—who have the responsibility of providing an environment in which our national productive infrastructure is available for use by all.

Our failures can be summed up by saying we only deregulated fares and routes. We missed airports, CRSs and other vital factors of production.

If we were to replicate the environment facing the air transportation infrastructure for road transportation, we would start by leasing all or at least the key existing interstate highway exits in our major metropolitan communities to the big nine trucking companies on an exclusive use basis for, say, 30 years.

Next, we would agree that before any existing public revenue sources, government grants or tax-free bond funds could go toward the improvement of the existing highway exits or the construction of any new ones, the community would have to seek approval for the tax exempt funding and use charging fees for the project from the big nine trucking companies. This approval would only be forthcoming upon the demonstration that the project was needed by the big nine cartel on the condition that they have the first right of refusal to lease some or all of the added capacity.

In most instances where larger exits and junctions were approved for construction, the cartel would extract a promise that a

commensurate number of old, existing exits be torn down or rendered unusable. Any competitor subsequently gaining the right of access to any new capacity would have to pay fees established on the basis of the cost of constructing the new exits while the big nine enjoyed the unit cost advantage achieved by averaging the cost of using old as well as new exits. This is done based on the theory that the big nine paid for the old when in fact it has been the consumers, you and I, who always end up paying the tab.

Communities would be prohibited from constructing alternate expressway systems to handle excess traffic without prior consent of the highway exit leaseholders.

Lastly, communities would be barred by leases with the big nine from charging tolls, fees, charges or rents in order to fund the construction of the new exits independent of the approval of the big nine because of Federal funding restrictions on use charges imposed on the basis of the argument that if such restrictions to assess appropriate fees were removed, local governments would misuse their revenue raising authority.

Under such circumstances there would be justified public outrage. Soon there would emerge a shortage of highway exits and junctions as traffic would grow faster than new exits were built. Opposition would mount quickly as it would be pointed out that the interest of those effectively controlling the public infrastructure were not for more road transportation and more highway exits, but in fact for less unless they needed the new capacity.

Editorials would be written condemning the practices being detrimental to the interests of the public and constraining on the local economy. The cost of moving interstate and local cargo would rise without a rational justification. That we should never leave the chicken coop of road transportation in the hands of the trucking company foxes would become a popular cry.

— Unfortunately, this description which sounds so ludicrous when applied to road transportation is a reality in air transportation.

Now, the environment I have described is attributable to four things: first, the practice of leasing public infrastructure to private corporations on a long-term exclusive use basis; second, the requirement that communities need the prior approval of leaseholders before being able to undertake capital improvements in air transportation known as majority in interest clauses; next, the Federal prohibition on the ability of local governments to raise revenues in a fair, efficient, equitable, reasonable and nondiscriminatory basis from the users of the public facilities; and last, the computer reservation systems must be neutralized.

Of the solutions that present themselves to these problems, none is more important and promises to be more effective in returning air transportation to a competitive environment than the repeal of the Federal prohibition on the airport collection of a passenger facility charge or some equivalent and the use of such charges and the trust fund surplus to leverage this surplus to \$60 billion without substantially increasing the Federal deficit, if you would call investing in America a deficit.

Thank you, sir.

[The statement follows:]

STATEMENT OF RICHARD H. JUDY, DIRECTOR, MIAMI INTERNATIONAL AIRPORT

Belatedly, airline concentration has been recognized as a serious threat to the many benefits the public has received from airline deregulation. The cause for concern over the level of airline concentration should arise, not because there are only six or so major domestic airlines, but instead because in an increasing number of markets (airports), only one or two airlines control the range, type, and price of air service offered to the consumer, as there is no meaningful threat of competitive entry.

As commentators have awakened to the rising number of airports at which there is a high level of airline concentration we have heard a barrage of opinions as to *why* and *how* airlines have fortified themselves in a few markets. There is a long list of factors that have been recognized by growing numbers of analysts. The list of factors includes the power derived from the ownership of Computer Reservations Systems, the control of regional and commuter carriers by the big airlines, and the use of market power derived from the operation of international routes in the domestic marketplace. Some are even beginning to comprehend the detriments to competition arising from the anti-competitive aspects of frequent traveller programs. The ownership of slots and the administration of the Federal slot program at the High Density Rule airports are widely regarded as contributing factors, but not in terms of the collateral impacts of such rules on both air and alternative ground transportation for the community served by the airport. The inability of the Federal Government to take the measures necessary to preserve competition through the provision of additional capacity certainly appears high up on the lists of many. But no matter how long the list of the factors leading to the increase in airline concentration might be, few have focussed on the airline control of the allocation of airport facilities and the process through which new facilities are planned, funded and constructed. This is a serious analytical shortcoming.

The role played by the factors that are behind the airline control of existing and future airport facilities, because of their complexity and subtlety, have so far eluded most persons looking for the causes of the rising level of airline concentration at airports. There should, however, be no doubt as to their relevance.

For example, the allocation of the take-off and landing slots at the five High Density Rule airports has been a festering sore which is opened for debate on what seems to be a biannual basis. Legislators worry that the method of slot allocation provides an effective barrier to entry to competitors. But few industry groups and commentators seem to have appreciated that at the majority of airports the equally if not more serious question is whether new entrants can gain access to competitively priced airport facilities needed once the aircraft is on the ground. The right to land at an airport, a subject on which we spend an inordinate amount of time debating in the case of the High Density Rule airports, becomes a side issue if the ability of a competitor to load and unload his passenger, is controlled directly or indirectly by the incumbent airlines at the airport. So far, we have failed to see the forest for the trees or if you like we have failed to see the gates, and related support facilities for the slots, Computer Reservations Systems and so forth. A slot is worth only as much as the money for which it can be sold to a competitor, if the slot owning airline has no competitive access to a gate and other related airport facilities needed for it to use the slot.

AIRPORT FACILITY CONTROL

The airline control of existing airport facilitation capacity including gates, ticket counters, and baggage carousels, most of which are financed directly and indirectly by tax exempt bonds, is the single most important factor contributing to the increase in the level of airline concentration at airports throughout the country. Airlines control not only the use of existing facilities but also the planning, funding, construction and allocation of new facilities. They control not only the existing and planned facilities for their own use but also those which would be required by a competitor, be that competitor a low cost carrier seeking to use lower cost ground-loading or a high service level carrier requiring a costlier range of facilities. Incumbent carriers can and do use their greater passenger volume to spread costs thinly for themselves but punitively for those competitors using the same facilities with a lower volume of passengers.

There are three major anti-competitive elements held over from the days of regulation affecting the use of airport capacity and the development of additional capacity, that give the air carriers the ability to foreclose markets to competitors and increase the level of concentration. First, existing facilities are controlled through long term exclusive-use leases—a practice established in the pre-deregulation era

that remains prevalent today. Air carriers have used the exclusivity of airport facility leases to deny competitors access to existing airport facilities directly through denial and indirectly through excessive use charges and competitor buy-outs.

The TWA-Ozark merger at St. Louis and the Northwest-Republic merger at Minneapolis are the most flagrant examples of market monopolization through the buying-out of an airline and its exclusive-use leases. In both cases the acquiring carrier became interested in buying its hub competitor not because of the aircraft that competitor owned or the skilled workforce it employed but instead because of the airport gates, ticket counters and bag carousels the buyer would control through the acquisition. Following these two mergers, Northwest in Minneapolis and TWA in St. Louis enjoy market shares in excess of 80%—in effect perfect monopolies.

Second, as part of the agreements that airport operators entered into with airlines for the development of new facilities in the pre-deregulation era, Majority In Interest clauses became commonplace. At even moderately concentrated airports, the requirement for a majority of resident air carriers to approve the funding and implementation of any sizeable program to develop the airport, including the facilities needed by a competitor, in effect gives such carriers the power to veto competitive entry or shift costs to penalize those attempting to gain competitive access.

Lastly, and most importantly, the Federally legislated prohibition on the airport collection of Passenger Facility Charges or PFCs as they are known, prevents local governments from acting independently of the airlines to respond to the needs of a competitive marketplace. Local governments are thereby prevented from doing their part to help foster a competitive environment in air transportation and provide the infrastructure necessary for local economic growth.

There should be no doubt, the Passenger Facility Charge in addition to the landing fee are the most efficient and equitable sources of revenue to meet the majority of airport operating and capital development costs for the overwhelming majority of the airports serving commercial air travelers and cargo shippers. This is especially true for those super-hub and key origin and destination airports that are the fundamental competitive foundation of the air transportation infrastructure on which all other airports rely to generate competition. Without airports being able to levy PFCs as well as landing fees, there is no realistic hope that airport access can become an influence that both promotes competition and assures a national commitment to provide and protect the competitive availability of future airport and airspace capacity (including complete new airports and the landbanking of future sites and related airspace).

ANALOGY

An analogy is perhaps the best way through which to impress upon this Committee how extraordinary and contrary to the public interest are the common practices regarding the allocation and control of existing and future airport facilities. If we were to replicate the environment facing the air transportation infrastructure for road transportation, we would start by leasing all or at least the key existing interstate highway exits and junctions in our major metropolitan communities to the "big nine" trucking companies on an exclusive-use basis for say, thirty years.

Next, we would agree that before any existing public revenue sources, government grants or tax free bond funds could go towards the improvement of the existing highway exits and junctions or the construction of any new ones, the community would have to seek approval for the tax exempt funding and use charging basis for the project from the "big nine" trucking companies. This approval would only be forthcoming upon the demonstration that the project was needed by the cartel of lease holding trucking companies and on the condition that they have the first right of refusal to lease some or all of the added capacity. In most instances where new exits and junctions were approved for construction, the cartel would extract the promise that a commensurate number of existing exits and junctions be torn down or rendered unusable. Any competitors subsequently gaining the right of access to new capacity would have to pay fees established on the basis of the costs of constructing the new exit or junction while the incumbents enjoy the unit cost advantage achieved by averaging the costs of using old as well as new exits and junctions.

Communities would be prohibited from constructing alternative expressway systems to handle excess traffic without prior consent of the highway exit and junction lease holders. Lastly, communities would be barred from charging tolls, fees, charges or rents in order to fund the construction of new exits and junctions independently of the approval of the "big nine" because of Federal restrictions imposed on the basis of the argument that if such restrictions to assess appropriate fees were removed, local governments would misuse their revenue raising authority.

Under such circumstances there would be justified public outrage. Soon there would emerge a shortage of highway exits and junctions as traffic would grow faster than new exits and junctions were built. Opposition would mount quickly as it would be pointed-out that the interests of those effectively controlling the public infrastructure were not for more road transportation and more highway exits and junctions but in fact for less. Editorials would be written condemning the practices as being detrimental to the interests of the public and constraining on the local economy. The cost of moving interstate and local cargo would skyrocket. That we should never leave the chicken coop of road transportation in the hands of the trucking company foxes would become a popular cry. Unfortunately, this description which sounds so ludicrous when applied to road transportation, is reality in air transportation.

SOLUTIONS

The three airport facility controlling powers of exclusive-use leasing, Majority In Interest type provisions and the prohibition on the airport collection of Passenger Facility Charges, have three solutions. First, we need to push for a legislative prohibition of exclusive-use leases for airport facilities that would nullify all such existing leases. Second, a similar measure should be taken to outlaw Majority In Interest type provisions that in any way constrain the ability of local governments to fully develop capacity as they deem necessary. In both of these cases we should solicit the assistance of the Justice Department by requesting their thorough examination of the anti-trust implications of such existing legal obligations, leading to appropriate action under anti-trust laws. We should perhaps even consider the imposition of an airspace use charge on all airlines holding exclusive-use leases at airports where entry by competitors is impeded.

Most importantly, the legislated prohibition against the airport collection of PFCs is in desperate need of immediate repeal. A repeal of the PFC prohibition represents the most effective response available to the growing problem of increased airline concentration in the absence of the threat of competitive entry. So long as local governments are barred from supplementing Federal funds by raising local funds to meet those local infrastructure needs that truly belong in the local domain, local governments have in effect no capacity to develop their airports in the way that best serves the consumer. Airports have no ability to help preserve a competitive marketplace in air transportation or to provide the airport infrastructure that is as critical to our productive capabilities as electricity or the telephone. Enhancing the capacity of an airport is perhaps the most effective method of returning a highly concentrated airport to a competitive environment, provided that an appropriate portion of such additional capacity is made available for new entry or provides the threat of new entry. The construction of a new airport if appropriately managed to provide competitive access opportunities, is the optimal solution. Our nation needs a source of funding which enables local governments to respond to the needs of their regional air transportation catchment area for competitive air service and which frees all of us from the shackles of anachronistic airline agreements that restrict capacity and competition.

Through the collection of PFCs or an equivalent efficient revenue source, opportunities abound to solve the problems that face airports and which contribute to the reduction in competition in air transportation. Just last week, for example, the Airport Operators Council International, an association of the local government entities that operate airports, regenerated the idea of a revolving loan fund for the improved efficiency of airport capacity development funding. The \$5 billion Trust Fund surplus could be leveraged to over \$60 billion in desperately needed financial resources to develop the airport capacity essential to preserve and further our national productive capabilities. This could be achieved with minimal negative impact on the Federal deficit—if you consider investment in our productive infrastructure to be a negative. A PFC combined with the other appropriate airport fees and charges are the optimal funding sources for such loan repayments.

There are usually three arguments that are raised in opposition whenever moves are afoot to have the prohibition on the airport collection of PFCs repealed. First, it is feared that a repeal of the prohibition on the collection of PFCs would be of benefit solely to those airports that can support themselves by such a charging mechanism. The collection of a Passenger Facility Charge, however, provides the means by which an airport can instill competition in the markets served at the airport, each of which has a far end destination that similarly benefits from the competition. Thus competition at say Miami benefits all communities that have air service to

Miami whether or not those destination points are sufficiently large to support themselves through the collection of a PFC.

For the record, we would never suggest and are not aware of any other airport party that would suggest that the repeal of the prohibition on the collection of PFCs be accompanied by the reduction of the Federal grant program as it presently applies to those airports of insufficient size to support themselves through the collection of a PFC. Even such airports will be able to use a PFC to augment Federal funding, thereby increasing their ability to provide needed airport infrastructure for their community and to bolster the competitive integrity of our national air transportation system.

Second, air carriers argue that exclusive-use leasing, Majority In Interest provisions and the ban on the collection of PFCs are provisions that are necessary to protect the risks of funding airport development the carriers have undertaken. Such arguments are fatuous. First, airlines do not fund the development of airport facilities, local governments do through tax exempt financing and then charge airlines appropriate rents and fees to repay the loans. The long term rental commitment reflected in exclusive-use lease agreements that airlines have entered into and which they pretend puts them at risk, reveals little quantifiable risk to the airline. No undue risk (contingent or otherwise) or any other commitment associated with airport facility leases, for example, are evident when you look through the balance sheets of the air carriers.

Our bond rating services realize there is no need for long term leases to guarantee the debt service on bonds as alleged by the airlines. The need disappeared in the early 1970s when air transportation became essential infrastructure and therefore a natural guarantor of future traffic and revenues. Today, "risk" can be shifted to the collection of landing fees and PFCs; a bargain for the traveling and shipping public when you consider that such charges allow their airline tickets to be priced competitively.

The only reason communities have not already assumed this "risk" is because the constraints we face prevent us from raising the necessary funds independently of the airlines. Long term leases would be needless if local governments were allowed the means through which to support their airports. The airlines are in effect arguing that since the airlines have had to do all the work, the airports should be forced to sit down and keep quiet when in reality it is because airports are forced to sit down and keep quiet, the airlines have assumed the role of doing the work.

The last argument that PFCs would be used to build "Taj Mahals" for which the airlines would end up paying, similarly carries no merit. Instead, the artificial constraints faced by airports today would be replaced by the rational but no less demanding constraints of the marketplace. Just as in any commercial relationship, the seller airport must take into account the wishes of the airline customer if the seller aspires to survive, providing there are enough sellers to provide the disgruntled buyer with an alternative. In the case of airports this is undoubtedly true.

A cursory glance around the industry today reveals that it is in fact difficult for airports to make a mistake when making the decision to build additional capacity. Air transportation is in the same state as road transportation was in the early 1950's when additional road capacity was in such demand that any new highway was a good investment. And airports are cheap to build. The new Denver airport and the capacity improvements at the New York airports represent costs in the range of \$5 to \$10 per passenger which is insignificant when the air fare savings from increased competition and the value of additional air service are taken into account.

FEDERAL LEADERSHIP

It is important that the Federal Government exhibit some leadership in the area of preserving a competitive environment in air transportation, and there is much it can do relatively easily that will send a clear message to airport operators that high levels of airline concentration without the meaningful threat of entry represent a serious threat to the public benefits of air transportation. First, this should involve a statement of policy which specifies that the reduction of airline concentration at highly concentrated airports where there is no meaningful threat of economic entry is a Federal objective.

Second, the Federal grant assurances should contain two new elements. There should be an assurance that no airport facilities, funded partially or in whole by Federal funds, will be leased on an exclusive-use basis or any other basis that unreasonably inhibits competitive entry. This assurance need not preclude month-to-month or even year-to-year lease terms providing there exists ample and unfettered

capacity to allow reasonable economic entry by competitors. There should also be a Federal grant assurance that unless necessary for safety or planned development of additional capacity, no existing facilities should be rendered unusable by a competitor.

CONCLUSION

Much of what has been stated may imply that we would suggest that the blame be laid at the feet of the air carriers. Nothing could be further from the truth. The airlines have behaved exactly as they should and exactly as we would want them to, for it is through their competitive efforts to monopolize markets and destroy their competitors that we derive the huge benefits the free market has to offer. Without competition we would not have innovation, and the pressures to improve service and cut costs. The airlines should not be blamed for undertaking every legal action to compete vigorously.

Instead, the rest of us need to accept the responsibility for having impeded the ability of local governments to exercise their proprietary rights with regard to airports. Irrespective whether one's political beliefs are to the left or to the right or in between, there is consensus that government is responsible for ensuring the provision and efficient use of the critical infrastructure on which our society survives. The airport facilities and air traffic control services needed by all air transportation are just such elements of critical infrastructure: together they constitute the highways in the sky. The ability of local governments to exercise their proprietary rights is important because we cannot let our critical productive infrastructure that is needed by all, be manipulated to the gain of a few. The companies and jobs directly involved in the industry are relatively small when compared to the thousands of companies and the hundreds of thousands of jobs that suffer the consequences of foregone economic growth.

As a first step towards returning the air transportation infrastructure to a competitive environment Congress should repeal the prohibition on the airport collection of Passenger Facility Charges. Though not widely recognized, airports are the key to the airlines building barriers to competitive entry and as a corollary, to any successful endeavor to maintain a competitive environment in air transportation. If you do not give local governments the tools with which to build that pro-competitive environment at airports, you will not be able to solicit any more than our vocal support for the conquest to reduce the level of anti-competitive airline concentration at the airports of our nation.

Senator FORD. Mr. Dunham.

STATEMENT OF ORIS W. DUNHAM, JR., DIRECTOR OF AVIATION, DALLAS/FT. WORTH INTERNATIONAL AIRPORT, REPRESENTING THE AIRPORT OPERATORS COUNCIL INTERNATIONAL

Mr. DUNHAM. Good morning, Mr. Chairman and members of the committee. I am Oris Dunham, Executive Director of the Dallas/Ft. Worth Airport and Chairman of the Airport Operators Council International.

AOCI is pleased to see the committee's interest in this issue which is increasingly becoming a greater concern to airport operators throughout the country.

The primary adverse effect of airline concentration is inadequate competition. Competition is necessary to keep our dynamic free market system in balance.

Further, it is the primary interest of us as local government entities that the strongest possible marketplace exist so that more people can travel more often.

Each time competition can lower the cost or improve the service to the consumer, the incremental improvements make it just that much more convenient, affordable and otherwise attractive to the consumer to travel by air.

As evidence that the airline industry has reached such a state of inadequate competition, a recent article in the "New York Times"

offers readers "a secret way to fly cheaper." The author, Jay Angoff, counsel to the National Insurance Consumer Organization, cited the fare from Washington to Detroit was \$230, but the fare to Lansing through Detroit on the same plane was only \$200. One rather very obvious solution to such rate differences and one being used indiscriminately and increasingly by wise travelers is to simply book passage to the further city and get off at the intermediate stop.

Senator FORD. I have done that, Mr. Dunham.

Mr. DUNHAM. This also contributes significantly to the problems of overbookings and delays because an airline with such a lopsided fare structure now has no idea if passengers are really going to fill the seats during the second leg or may disappear in mid-journey.

Other examples of this are located in our written testimony.

Available statistics, as we have attached to our testimony, show that carriers which dominate specific airports are realizing substantially higher yields from local passengers, those which originate or terminate their trips at dominated airports, and substantially lower yields from connecting passengers, than those who are simply passing through those airports on their way to someplace else.

While we continue to embrace the principles of airline deregulation, which on balance has been enormously beneficial, we are nevertheless concerned over the extent of which recent consolidations are resulting in the less desirable levels of competition. Airline deregulation was supposed to stimulate competition and drive down prices.

For several years the idea worked, but when the airline industry followed a familiar and unfortunate pattern after a period of vigorous fare competition, many airlines failed or were gobbled up in acquisitions. Then the beneficial tide began to turn. Further consolidations were allowed among even strong carriers. The survivors have begun jacking up prices and, in effect, a private market cartel has begun to form.

Although in theory new competitors will move into the noncompetitive market, it is not easy or cheap to start an airline. Furthermore, barriers to the new entrants exist that were not nearly as large in 1978. For example, many airport gates were leased exclusively and for many years by various airlines. But after mergers these gates are now held exclusively and for the long term by only a few carriers. Naturally, dominant carriers then resist capacity expansion because additional competition is an anathema to profits.

During the AOCI annual conference last week, AOCI members adopted a resolution recognizing this problem, supporting maximum competition at U.S. airports and expressing concern over the growing concentration and dominance at many airports, especially major hubs by a few major carriers. AOCI has determined to further investigate the situation and to develop suggestions on what can be done. A copy of our resolution is attached to our statement for the hearing record.

Although AOCI has just begun to study these developments and to develop positions on what should be done, the essence of our belief is that adequate opportunity for new service competition is

the only desirable long-term solution to the problem. We are examining certain actions the Federal Government, as well as local government, airport operators might take to enhance competitive opportunities and to, therefore, alleviate the adverse effect of airline concentration.

First, Congress should work vigorously to encourage new airport capacity where needed by appropriating the full amount of the funds authorized for the airport improvement program. There are some innovative ideas for additional funding to supplement AIP, and one in particular endorsed by the U.S. airport membership last week offers a great deal of flexibility and is in the development process at AOCI. It is a proposal to create an airport revolving loan fund based on the airport trust fund.

Further, Congress and its new administration should develop a comprehensive transportation policy articulating the Federal role and rebuilding the Nation's transportation infrastructure and integrating the priorities for development of airport capacity.

To an extent, provisions in current airport-airline leases, called majority-in-interest clauses, give dominant airlines not only substantial control over the use of existing facilities, but over the development of new facilities as well, to the detriment of potential competitors. However, hub airports alone are not in a strong position to eliminate these provisions, given their reliance on airline financial guarantees to back airport revenue bonds. Congress should also revisit the current prohibition on passenger facility charges, which would provide airports a reliable source of capacity expansion funding outside the control of dominant carriers.

Furthermore, the problems that have arisen stem in some cases from this administration's approval of airline mergers and acquisitions, reflecting policies which we suggest do not accurately interpret nor adequately enforce antitrust laws and regulations. As a start, the D.O.T. could refuse to allow any additional airline mergers or acquisitions which would result in further concentration.

Also, we are convinced that the Federal Government should abolish the slot buy-sell rule, which generally allows dominant carriers to keep a death grip on limited capacity at the four high density airports. Further, D.O.T. must develop a new method of allocating their landing slots to ensure fair distribution of competitive opportunities.

Airport operators recognize that they must make every reasonable effort to expand competitive opportunities by adding capacity where possible and to market the competition carriers the opportunity to use new airport capacity.

Additionally, to ensure that competitors are able to operate on fair terms and reasonable costs, airports must be able to control sublease by a major tenant airline and other competitors. We know the situation where airline subtenants are required to pay rent to a dominant tenant airline which is substantially greater than those paid to the airport by this tenant. Unfortunately, airports are not in a legal position to do anything about these unfair practices. Not only does the competitor suffer unreasonably high costs of doing business compared with other carriers, but the tenant airline makes a profit from the public facilities it leases.

In closing, let me reemphasize that airports as public agencies have an intense, direct interest in maintaining the economic viability of each of our communities and their access through airports to the rest of the Nation's economy. The various oligopolies beginning to develop at the airports work against the best interest of the traveler, and the problem must be addressed at the congressional level.

Among the approaches we recommend are: greater capacity through additional Federal spending; stronger antitrust enforcement including refusal to allow mergers which result in market concentration; innovative supplemental financing methods such as the revolving loan fund and the passenger facility charge; and revisiting of such market restricting techniques as slot distribution and airline leases.

There are many complicated elements to fine-tuning some of the unforeseen results of deregulation. By and large, the system works, but this committee is right on target in seeing that the marketplace is not abused.

Thank you.

[The questions and answers follow:]

QUESTIONS OF THE CHAIRMAN AND THE ANSWERS THERETO

ADDED CAPACITY

Question 1. Everyone seems to agree that we need to build additional airport capacity. Yet, I am interested in how this will help consumers. At any airport, if the traffic were there, the airlines would be battling to get in to serve that city. It seems unclear that many cities don't already have the capacity needed to accommodate the traffic that begins and ends its trip there. Where do we really need additional airport capacity?

Answer 1. Airport capacity describes the ability of an airport to handle landside and airside traffic. The ability of airports to handle the demand, along with the rest of the aviation infrastructure, determines the capacity of the national transportation system. Various components of an airport complex can exceed the capacity to efficiently accommodate traffic: groundside access, such as roadways, terminal and gate facilities, and runway and taxiways on the airside. Serious congestion in one part of an airport impacts the others and prevents the smooth and efficient operation of the entire airport. For example, while an airport may have sufficient runway capacity, inadequate gate capacity can tie up aircraft and enplaning and deplaning passengers, thus causing delays.

Increased capacity is needed at many origination and destination airports and at the major hubs which handle the bulk of connecting traffic from which congestion and delay problems ripple throughout the system. The FAA's estimates of AIP-eligible airport development needs clearly demonstrates that airports of all sizes and categories have capacity needs—72% of the \$24 billion, ten-year NPIAS estimate is for increasing airport capacity.

While nearly all airports have some capacity needs, we believe the highest priority should be given to increasing capacity at those airports which impact the capacity of the air transportation system as a whole. FAA projections show that delays and their cost to passengers and air carriers will increase dramatically at many airports unless capital investments are made to increase capacity. Eighteen airports are seriously congested today, experiencing more than 20,000 hours of delay annually, and some 32 airports will become congested by 1996, affecting 76% of all passengers. These delays are costly—every 20,000 hours equals approximately \$32 million in increased air carrier costs. We have attached for the record a list from the FAA's 1988 Airport Capacity Enhancement Plan showing current and future delay projections for the most congested airports.

From the consumer's perspective, the cost of delays is eroding many of the benefits of deregulation. Air passengers now pay about \$4.5 billion annually because of delays. Failure to build new airports and expand existing ones will leave our air transportation system ill-equipped to handle the traveling public's growing demand

for air service, which is expected to grow from 450 million passengers in 1987 to 780 million by the year 2000. Passenger delay costs will increase sharply, and to the extent a lack of airport capacity constrains competitive air service opportunities, air fares will inevitably increase as well.



FIGURE 1-B. AIRPORTS FORECAST TO EXCEED 20,000 HOURS OF ANNUAL AIRCRAFT DELAY IN 1996, ASSUMING NO CAPACITY IMPROVEMENTS

TABLE 1-6. PRESENT AND FUTURE AIR CARRIER DELAY AT 50 SDRS AIRPORTS
1986 - 1996

AIRPORT	TOTAL HOURS OF DELAY		PERCENT CHANGE 1986 - 1996
	1986	1996	
Denver Stapleton International	38,400	158,200	312.0
Chicago O'Hare International	133,200	156,000	17.1
Atlanta Hartsfield International	87,600	103,300	17.9
Dallas/Fort Worth International	76,000	90,000	18.4
Newark International	60,000	67,100	11.8
Phoenix Sky Harbor	24,200	66,200	173.6
Los Angeles International	56,200	61,900	10.1
St. Louis Lambert International	35,100	59,900	70.7
San Francisco International	57,100	59,000	3.3
Detroit Metropolitan	27,200	57,700	112.1
Washington Dulles	12,900	54,300	320.9
New York La Guardia	43,300	47,000	8.5
Boston Logan International	34,500	46,700	35.4
Honolulu International	23,800	44,500	87.0
New York Kennedy	33,000	43,800	32.7
Minneapolis-St. Paul International	29,700	43,700	47.1
Orlando International	13,400	43,600	225.4
Philadelphia International	18,700	41,700	123.0
Miami International	31,000	41,500	33.9
Salt Lake City International	14,700	30,300	106.1
Houston Intercontinental	16,400	29,100	77.4
Washington National	24,300	28,800	18.5
Memphis International	18,300	27,000	47.5
Kansas City International	13,600	26,000	91.2
Pittsburgh International	20,000	24,500	22.5
San Jose Municipal	12,100	24,300	100.8
Seattle Tacoma	17,500	24,100	37.7
Las Vegas International	14,100	23,700	68.1
Nashville Metropolitan	11,300	23,500	108.0
Cincinnati Municipal	6,800	23,400	244.1
Ontario International	8,400	22,600	169.0
Raleigh/Durham	4,800	21,600	350.0
Tampa International	10,400	19,300	85.6
San Diego International	13,400	19,100	42.5
Baltimore-Washington International	11,800	16,800	42.4
Cleveland Hopkins International	11,900	12,700	6.7
Albuquerque International	7,200	12,400	72.2
Dayton International	9,500	12,400	30.5
Port Columbus International	4,600	12,300	167.4
Windsor Locks Bradley International	6,000	11,900	98.3
Oakland International	6,800	11,600	70.6
Milwaukee Mitchell Field	6,000	11,000	83.3
Portland International	8,800	10,100	14.8
New Orleans International	5,300	8,500	60.4
San Antonio International	6,100	8,000	31.1
Austin Mueller Municipal	4,700	7,000	48.9
West Palm Beach International	4,400	7,900	79.5
Indianapolis International	5,800	6,900	19.0
Sacramento Metropolitan	4,000	5,200	30.0
Jacksonville International	4,200	5,100	21.4

HEAD TAXES

Question 2. You call for the re-imposition of the Passenger Facility Charge as a means of financing airport development. Yet, this proposal for "head taxes" was rejected last year by both the House and Senate. Why do you think this approach should be reconsidered?

Answer 2. We are now facing an airport financing crisis. Despite the commendable efforts by this Committee to substantially increase Trust Fund spending for the airport grant program in the 1987 reauthorization, the federal deficit and budget constraints have precluded full funding of the program. So long as the Trust Fund remains on-budget, that is not likely to change. Airport funding is being squeezed not only by inadequate AIP appropriations, but also by tightening of tax exempt financing by the 1986 Tax Reform Act, which has increased airport borrowing costs. The airport community fully expects further attempts in Congress to restrict the use and/or tax exempt status of airport and other municipal bonds, particularly in light of the recent Supreme Court decision which eliminated the long-standing Constitutional protections. Airports also face threats to existing revenue sources from certain airport users seeking federal restrictions on airport rates and charges.

In sum, airport financing sources are already limited and may be diminished further, at a time when airport capital development needs are growing dramatically. The only avenue left is to find new financing methods. AOCI is proposing the creation of a federal airport revolving loan fund to utilize a portion of the Trust Fund surplus and provide the more than \$1 billion in capital financing that is needed annually, over and above current AIP and bond funds. The need for airport expansion combined with the increasing concentration and dominance of some airlines at key airport hubs also compels us to pursue funding sources outside the control of the airlines. Passenger facility charges (PFCs) are such a source.

PFCs were prohibited at the behest of airlines who did not want airports to have a reliable flow of income outside their control. Arguments made against PFCs, such as the "administrative burden" to the airlines of collecting PFCs, are nothing more than smoke screens. Witness that, in protest, airlines have found no difficulty whatsoever in adding surcharges to the airline ticket prices to recover from passengers "their costs" associated with locally imposed fuel taxes or other charges. Reasonable safeguards and restrictions could be placed on PFCs and their use to satisfy those that fear airports would exploit them or that PFC revenues would be taken off the airport. In our view, however, the current propensity of dominant airlines to exploit their ability to control airport expansion for market advantage is a far greater threat.

PFCs would provide adequate, reliable cash flow which airports could use to secure debt to expand. PFCs would not be a large or burdensome cost to passengers, and they could be offset by reductions in landing fees on a cost recovery basis. This is because airports have no stockholders to please with dividends, and all airport revenues must be used exclusively for airport operating and capital expenditures. It is absurdly ironic that airports could legally charge airlines on the basis of the weight of their aircraft, or on the number of flight attendants on board, or the number of beverages served, but they are prohibited from charging users on the basis of the single most relevant traffic variable which drives the need for airport facilities: the number of passengers handled. If the federal government is unwilling to provide airports the full resources of the Trust Fund, or their tax-exempt borrowing capabilities, then we believe it is the responsibility of the government to allow airports to use other local financing sources. The time has come to reconsider PFCs.

BUY-SELL RULE

Question 3. Mr. Dunham, you advocate abolishing the Buy-Sell rule. This Committee has tried to do that several times since 1985 when it was first imposed. However, there is no consensus on what the alternative should be. What is your suggested solution to slot allocation?

Answer 3. AOCI believes that first and foremost slots should be returned to the public domain where they belong, and should not be private property of the airlines. As we proposed in testimony before this Committee in 1985, AOCI supports the use of periodic auctions or short-term leases as the best and fairest means of allocating landing and take-off slots. We have suggested that 75% of the slots at each high density airport should be grandfathered, to preserve service stability and in recognition of the investment that airlines holding those slots have made at those airports, and that the remaining 25% of slots should be periodically auctioned or leased for temporary use. A slot auction would provide ample opportunity for new entrants and carriers wishing to increase service to compete for slots. An aftermar-

ket would also be created whereby auctioned or leased slots could be subleased from one carrier to another, again for temporary use, to accommodate scheduling and service changes.

The DOT "buy/sell" rule did nothing to increase the capacity of the high density airports. One of the benefits of our approach is that auction proceeds would be devoted to increasing airport capacity at these slot-constrained airports, thus encouraging new competition, rather than leaving slot under the permanent control of incumbents to stifle competition and preserve the status quo.

AIRPORT LEASING

Question 4. Mr. Durham, you also argue that airports should be allowed to control all subleasing by the major tenant airlines. Is there any precedent for such an action? Do you believe this would significantly open up the major airports to new competitors?

Answer 4. Some airports have already taken steps to recapture some degree of control over airline subleasing. However, the length of existing airport-airline use agreements and the leverage the dominant airlines presently have are major obstacles for many other airports. Subleasing by major tenant airlines has in some instances impeded competition by the simple means of controlling who will or will not have access to critical airport facilities, and at what price. There are instances in which a dominant carrier leasing space from an airport has subleased only to non-competing carriers at a significant profit, thereby stifling competition and diverting that revenue from the local government which operates the airport and "owns" the gates. Where tenant airlines do sub-lease to a competitor at a substantially marked-up rate, the competitor is forced to accept higher "doing business" costs as the price for the opportunity to compete, which undermines his ability to offer lower, more competitive fares.

Airport control over subleasing may not significantly improve competitive opportunities, but if accompanied by other actions we have discussed, it can certainly help, particularly at airports with limited gate capacity. It would also help ensure fairness and a more level playing field for new entrant subtenants, thereby protecting their financial health and competitiveness.

Question 5. Why can't airports do away with exclusive-use leases and the Majority-In-Interest clauses that you cite as being such problems once they come up for renewal? Why is it necessary for Congress to intervene?

Answer 5. Majority-in-Interest (MII) clauses are anti-competitive tradeoffs entrenched in long-term use agreements at many airports, particularly at connecting hubs and at airports where they were entered into for 25 or 30 years and are still in force. As background, airport charging practices fall into two general categories: residual cost pricing and compensatory pricing. If an airport needs and agrees to a residual cost approach with one carrier (a connecting hub operator, for example), it must use the same approach for all carriers, even if others do not operate a connecting hub.

Airline dominance is particularly troublesome at connecting hub airports because majority-in-interest clauses are far more common under residual cost pricing, which is most common at connecting hubs. Airports enter into residual cost agreements with MII clauses in return for signatory carriers' guarantees that the airport will break even each year. These trade-offs are difficult for hub airports to escape or avoid because they need the carrier guarantees more than airports which accommodate primarily origination and destination traffic.

We know of no airport operator who desires the MII clause; they are forced into them by the signatory airlines in exchange for essential guarantees that the airline will continue to serve the airport which provides connecting hub facilities and is obligated for the associated debt. Because airports with high proportions of connecting traffic do not have the negotiating clout to avoid MIIs, Congressional intervention is the only apparent way to preclude these anticompetitive terms.

As opportunities arise, airports are definitively moving in the direction of resuming greater control over their finances and expansion. At least 15 percent of the large and medium airports surveyed by CBO in 1984 have granted new carriers relatively short-term terminal leases and/or use agreements, such as five years or less, and they are month-to-month in some cases. As old contracts expire, many airports are routinely shortening the terms of airline contracts, and are modifying residual cost agreements, such as implementing more compensatory methods of calculating airline fees and charges, weakening or eliminating MII clauses, and including provisions allowing greater retention of earnings for capital development. Many other

airports with agreements expiring in the near term have indicated a desire or intent to move towards a more compensatory approach and to avoid MII allowances.

The problem with this piecemeal approach, however, is that adequate relief may not come about soon enough to allow airports to expand adequately and expeditiously. As shown in the attached table taken from the 1984 CBO study, many airport agreements involving MII clauses will not expire for many years, so those airports will continue to be subject to the consent of their signatory airlines. These include Atlanta Hartsfield (contracts expiring in 2010), Chicago O'Hare (2018), Los Angeles International (1992), Seattle-Tacoma (2001), Detroit (2009), Philadelphia (2006), Orlando (2008), Cleveland (2005), Memphis (1999), Cincinnati (2002), Milwaukee (2010), Tulsa (2008), Nashville (2005), and Tucson (2006).

Senator FORD. Mr. Cozzi?

STATEMENT OF ROBERT COZZI, VICE PRESIDENT OF REVENUE MANAGEMENT, TRANS WORLD AIRLINES, INC., ACCOMPANIED BY VINCENT MARTINELLI, VICE PRESIDENT OF DOMESTIC PRICING

Mr. Cozzi. Good morning and thank you for the opportunity to testify. I am accompanied today by Vince Martinelli, our Vice President of Domestic Pricing for TWA.

And rather than go through the testimony, I would just like to highlight a few items that we had in the testimony.

In 1987 the top 14 airlines in the U.S. industry made \$131 million for only a 0.3 percent return on sales. This is versus 4.7 percent for the 700 largest industrial companies in what was a very solid U.S. economy.

The cost of modernization of our respective fleets, which was contained in one of our exhibits, has increased dramatically. Total airline profits for the 14 carriers were only sufficient enough to buy one new 747 at the end of 1987.

The fact is that average airline prices have significantly lagged the CPI and have, in fact, declined since 1982. This is due to the fierce competition which exists in the airline industry. Meanwhile, hotel prices, a sister field, have seen their prices increase 38 percent. TWA's yield on a similar basis since 1982 actually declined 6 percent versus an industry decline of 1 percent.

Discount usage in 1987 was over 90 percent of the industry's traffic this versus 37 percent in the year just prior to deregulation. TWA, for example, currently has 93 percent of its passengers traveling on some form of discount. So, we are slightly ahead of the industry.

In one of our exhibits we compared TWA's current fare structure to that which exists in either Atlanta or Chicago on a by-hub basis. And whether you are looking at St. Louis, whether you are looking at Atlanta or whether you are looking at Chicago, the fare structure amongst the airlines is exactly the same. In fact, our exhibit shows that TWA's fares versus that of Delta in Atlanta and United at Chicago had a 200-mile stage length, are actually lower, and they are actually lower at an 800 mile stage length. That is 800 miles out of Chicago or 800 miles out of Atlanta.

We are roughly equal at a 400-mile stage length, and all we are trying to say is that TWA's fares in the current environment are exactly the same over a given mileage block that you will find with any of the other airlines.

Thank you. That is all I have.

[The statement and questions and answers follow:]

STATEMENT OF ROBERT COZZI, VICE PRESIDENT OF REVENUE MANAGEMENT, TRANS WORLD AIRLINES, INC.

My name is Robert Cozzi and I am vice president of revenue management at Trans World Airlines. I am accompanied today by Mr. Vincent Martinelli and Mr. Paul Biederman, who are in charge of domestic pricing and economic analysis for TWA.

It is our understanding that the committee's purpose is to examine hub pricing and service. We have been asked to comment on fares and service at our St. Louis hub and the general state of competition in the airline industry. In order to do this let us examine the industry in general.

While we sometimes hear complaints about high fares, the traveling public as well as the media seem to be unaware that the financial performance of the airline industry is in reality quite poor. 1987 was a strong economic year in the U.S. economy. However, total net income of the fourteen largest airlines was only \$131 million (attachment I).

The rate of return on stockholder's equity for the airline industry was only 1.1%. The rate for the 700 largest U.S. companies by contrast was in excess of 12%. The airlines return on sales was just as poor at 0.3% versus 4.7%.

The Nation's largest corporation, General Motors, in what was described as a terrible year, earned \$3.6 billion for a 10.7% return on equity and 3.5% on sales.

In 1988, airline profitability should improve modestly, but will continue to lag behind the rest of U.S. industry. It is difficult to understand that if the airlines are overcharging the public, why then are there not impressive profits being realized. Cumulative airline industry profits in 1987 were only sufficient enough to but one new wide-body 747-400 aircraft (attachment II).

I would point out that the average airline price, commonly referred to as yield, is lower today than in 1982. It lagged behind the gain in the consumer price index over the same period by 22 percentage points (attachment III). The percentage increases in food, medical care and other forms of public transportation, which take a much larger proportion of the consumer dollar, have dwarfed average airline price increases in the last five years.

Since deregulation, passenger volumes have almost doubled, and discount fares have become the norm. In 1977, the last year under regulation, 37% of the passengers flew on discounted fares. In 1987 over 90% of the public were flying at discounted rates. Where the discount amounted to one-third off the full fare in 1977, the current average discount exceeds 60% (attachment IV). The fact is that relatively few travelers today (only 9%) actually pay full fare because of the easy availability of discounts.

In fact only those airlines able to carry significant levels of business travelers can make money because, for the most part, current discount fare levels are uneconomical. An indication of this is that Continental Airlines, despite its standing as the lowest cost airline, has lost \$232 million thus far in 1988 after losing \$258 million in 1987. This is because Continental has had difficulty in attracting business travelers and thus must fill its planes almost exclusively with discount traffic.

Let me now review hubs in general and St. Louis in particular. As you know, hubs were created in response to deregulation by carriers who believed they needed to build strongholds to protect important sources of traffic.

We assembled data that reflects airlines non-stop full fare coach prices from Washington to the principal cities they serve (attachment V). This information indicates that TWA fares are lower than those of most of its competitors, ranking eighth out of thirteen in mileage-based cost.

Moreover, when St. Louis is compared to Chicago and Atlanta, both of which are large enough to support two or more carriers, St. Louis full-fare prices are nearly identical in markets where the mileages are similar (attachment VI). In 200 mile segments, for instance, TWA's full coach fares on four sample segments were slightly less expensive than those for United, but more costly than Delta's prices out of Atlanta. In the 800 mileage block, TWA's four sample segments were less expensive than those of both United and Delta (attachment VII).

It is important to note that having two or more carriers in a market as opposed to one is no guarantee of lower prices. For example in the hotly contested New York—Washington shuttle market, Eastern, Pan Am and Continental each charge \$99 or 36 cents per mile which is up by 41% from the \$70 fare of only two years ago.

A major factor in determining price competition which is unlikely to change, is the wide-range of options available to the consumer. Virtually every non-stop city

pair in the country can have its price undercut by a direct or connecting flight from a competing airline, thus, even if one cannot obtain a discount on a non-stop flight, a traveler can usually get a lower-priced one-stop flight and avoid paying a full-fare if he is willing to put up with a slight inconvenience. Since 91% of all travelers are on some type of discount fare, this is regularly occurring. Hubs tend to overlap each other and this factor will continue to prevent so-called monopoly carriers with non-stop service from overcharging the consumer.

Business travelers complain that fares are too high. Although we do not agree, what would be accomplished by placing some form of cap on full fares? Given the airline industry's poor financial performance, not just in 1987 but for most of the deregulated era, the industry would inevitably be forced to raise prices at the low end of the spectrum where 91% of its traffic is located.

In many instances, the cost of one night in a hotel exceeds the cost of the transportation. A passenger can fly from Los Angeles to New York City for as low as \$129 where the cost of a room at the New York City Hyatt is currently \$220 per night.

It is important to recognize that the cost of doing business continues to rise for the airlines perhaps disproportionately to other industries. Buying a new MD-80 is 130% more expensive than the 727 which it replaces. A new 747 costs 180% more than it did in 1977. Once again, average industry prices have only gone up by 41% since 1977.

I should emphasize that if prices are reregulated thereby diluting the airlines' revenue flow, a guarantee of a reasonable rate of return must follow if airline bankruptcies are to be averted.

Such a proposal may be welcomed by the airlines since our return on sales, as previously stated, is abysmally low as compared to other industries. The airlines are all faced with significant restructuring costs in the years ahead. Only through achieving a reasonable rate of return will they be able to provide affordable and reliable transportation in the years ahead.

Thank you for this opportunity to appear before the committee today. I will be pleased to answer any questions you may have.

ATTACHMENT I—COMPARATIVE INDUSTRY YARDSTICKS—1987

	Top 14 airlines ¹	36 other transportation	Largest 700 industrial and service ²	General motors
Net profits (billions of dollars).....	0.131	3.2	107.4	3.6
Profits per firm (millions of dollars).....	9	89	153	3,600
Profits/stockholders equity (percent).....	1.1	8.5	12.5	10.7
Profit/sales (percent).....	0.3	4.6	4.7	3.5

¹Excludes \$339 million gain for Alleges from sales of nonairline properties.

²Excludes financial and insurance.

Source: Fortune, April 25, 1988, pp D1-58, June 6, 1988, pp D3-34

ATTACHMENT II—COST OF REPLACEMENT AIRCRAFT

	Dollars in millions			Percent	
	1977	1982	1988	1988/1977	1988/1982
Narrow body:					
727-200.....	10	15			
MD-80.....			23	130	53
Wide-body:					
747-200.....	40	74			
747-400.....			112	180	51

ATTACHMENT III—AVERAGE AIRLINE FARE VS. SELECTED PRICE CHANGES

	1988* VS:	
	1977	1982
Domestic average airline price ¹	+ 41	(1)
Hotels	+ 147	+ 38
Total CPI	+ 93	+ 21
Food (CPI)	+ 78	+ 20
Medical care (CPI)	+ 140	+ 48
Public Transportation (CPI)	+ 144	+ 29

* First six months.

¹ Total industry.

Sources: Bureau of Labor Statistics; DOT Data base; Pannell, Kerr, Forstar.

ATTACHMENT IV.—Increased discounting under deregulation

Discount traffic percent of total:	Percent
1977	37
1988	91
Change	+ 54
Average discount (from Y):	
1977	33
1988	63
Change	+ 30
Total average price (cents):	
1977	8.61
1988	12.12
Change (percent)	+ 41

Sources: Air Transport Assoc.; DOT data base.

ATTACHMENT V—FULL COACH FARES TO WASHINGTON D.C. ¹

Market	Y fare (dollars)	Miles	Yield ² (cents)	Dominant carrier
1. Boston, MA	290	406	66.1	Eastern
2. Nashville, TN	325	552	54.5	American
3. Detroit, MI	230	391	54.5	Northwest
4. Louisville, KY	240	462	48.1	Piedmont
5. Chicago, IL	305	590	47.9	United
6. Charleston, WV	120	239	46.5	Piedmont
7. Milwaukee, WI	280	623	41.6	Northwest
8. St. Louis, MO	305	707	39.9	Trans World
9. New Orleans, LA	395	956	38.3	Continental
10. Dallas, TX	410	1,176	32.3	America
11. Phoenix, AZ	470	1,961	22.2	America West
12. Los Angeles, CA	550	2,294	22.2	United
13. Seattle, WA	529	2,312	21.2	United

¹ Non-stop service.² Excludes federal transportation tax.

ATTACHMENT VI.—Domestic hub comparison nonstop markets by mileage block

STL (TW)

Mileage block 200:

SGF/CID/IND/MKC:

Average Y fare	\$195
Average haul	222
Yield	0.813

Mileage block 400:

LNK/CMH/TOL/SUX:

Average Y fare	\$240
Average haul	396

Yield	0.561
Mileage block 800:	
ORF/SAT/DEN/SYR:	
Average Y fare	\$320
Average haul	789
Yield	0.376

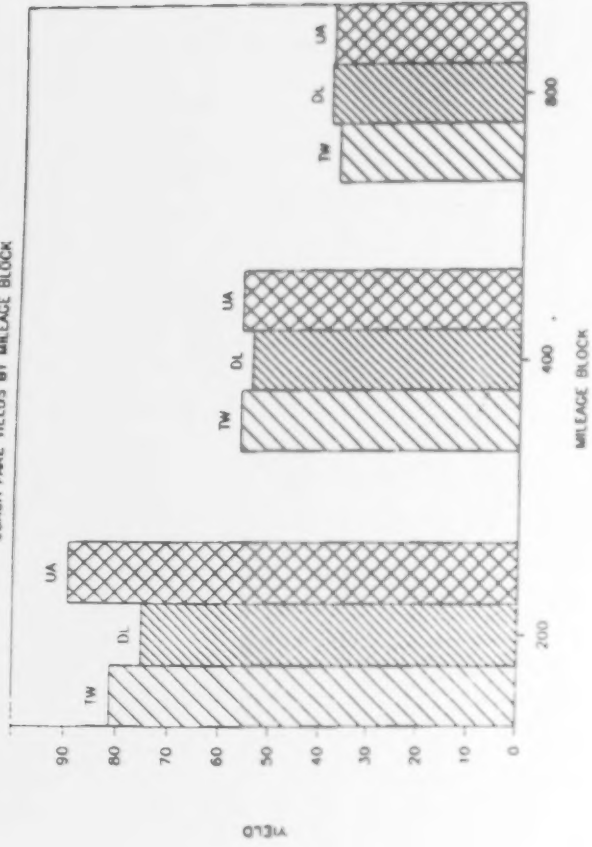
CHI (UA)

Mileage block 200:	
CID/DAY/DTT/CVG:	
Average Y fare	\$227
Average haul	232
Yield	0.894
Mileage block 400:	
BNA/MKC/PIT/OMA:	
Average Y fare	\$250
Average haul	411
Yield	0.563
Mileage block 800:	
BDL/SAV/DFW/MSY:	
Average Y fare	\$336
Average haul	797
Yield	0.390

ATL (DL)

Mileage block 200:	
MGM/BNA/SAV/JAX:	
Average Y fare	\$173
Average haul	213
Yield	0.752
Mileage block 400:	
RDU/CVG/MCO/MSY	
Average Y fare	\$226
Average haul	387
Yield	0.541
Mileage block 800:	
OKC/NYC/AUS/OMA:	
Average Y fare	\$334
Average haul	786
Yield	0.393

DOMESTIC HUB COMPARISON
COACH FARE YIELDS BY MILEAGE BLOCK



QUESTIONS OF THE CHAIRMAN AND THE ANSWERS THERETO

AIRLINE DEBT

Question 1. Mr. Cozzi, you mentioned the airline industry's net income of only \$131 million. Yet, last year the industry had a record operating profit of \$2.5 billion. Isn't it true that much of the difference is the result of debt issued over the last two years to finance the mergers and acquisitions? Hasn't that put a severe drain on earnings?

Question 2. How much debt did TWA take on as a result of the acquisition of Ozark Airlines? How has it affected your earnings?

Answer 1 and 2. In my statement to the Committee, I noted that net airline profits in 1987 totaled \$131 million for a 0.3% return on sales. These figures were based on the carrier financial data of 14 airlines as reported in Fortune Magazine. However, we have recently reviewed U.S. DOT form 41 data indicating that total industry profits (excluding all-cargo Federal Express and Flying Tigers) amounted to \$227 million, and that operating profits reached \$1.9 billion, slightly below the \$2.1 billion earned in the record year of 1984. While not as timely as company reports, form 41 data is considered the authoritative source since it reports financial data from airline operations only, thus segregating non-airline results. Despite the adjustment, airline profitability ratios are still woefully inadequate compared to the rest of American industry. For instance, the revised 1987 numbers show a 0.5% (instead of 0.3%) return on operating revenue (sales) compared to the 4.7% rate achieved by the nations' largest 700 companies. Put another way, the airline industry earned one-half cent on the dollar while, for example, two of South Carolina's biggest companies—Springs Industries in Fort Mill and Sonoco Products in Hartsville—made 3.4 cents and 4.7 cents respectively. As for the question of the impact of airline debt (again based on form 41 data), total airline interest paid on debt amounted to \$1.6 billion in 1987, the same as in 1986 and only slightly above the \$1.5 billion in 1984 when merger activity was nil. Moreover, as a percentage of total operating expense, 1987's interest costs were 3.2% down from the 3.8% posted in 1984. With regard to the debt issue relative to mergers and acquisitions, another way of framing its impact is that it is simply an alternative method for a carrier to purchase aircraft. TWA spent \$250 million to acquire Ozark, but it is difficult to estimate the exact amount of new debt incurred since many other actions took place in 1986. Nevertheless, it is fair to state that over a period of time operating economies resulting from the merger will far outweigh the acquisition expense. TWA obtained 50 additional aircraft as a result of the merger which has allowed the corporation to expand its flying and maintain a more competitive posture in the industry. It should be noted that despite the merger, TWA ranks only seventh out of the eight major U.S. airlines and thus remains a relatively small carrier in terms of total U.S. domestic service.

OZARK MERGER

Question 3. GAO reported that, according to TWA officials, one of the reasons fares seemed higher today was the intense level of competition with Ozark in 1986. As a consumer, why wouldn't I want that kind of competition? Do you believe the consumer is better off with higher fares and little, if any, competition?

Question 4. Can you tell us, why did TWA acquire Ozark? What was the primary reason for the merger?

Answer 3 and 4. One of the key points TWA made with the GAO staff in contesting 1988/1986 average price comparisons was that TWA and Ozark were in the final stages of a long-running destructive price war, and thus 1986 had a severely depressed base. As proof that the 1986 fares were abnormally low, TWA alone accumulated losses in St. Louis totaling \$80 million after losing \$160 million during the prior two years. We have since offered evidence to support our contention that TWA's current pricing structure in St. Louis is no different on an equal mileage basis than that charged by United Airlines in Chicago, Delta in Atlanta or Continental in Houston. The fact is that St. Louis as a hub, like Pittsburgh, Minneapolis, Detroit, Kansas City and others is not large enough in population or in terms of local traffic content to profitably support more than one carrier. That is why the TWA-Ozark merger was inevitable. The same is true for St. Louis' neighbor, Kansas City, where a non-compensatory fare structure recently forced Eastern to abandon the market.

Another factor which severely depressed TWA's traffic and fares in 1986, which I did not address in public testimony, is that TWA had, in effect, become an instrument of foreign policy at enormous expense to the corporation during that year. As

you know, terrorism activity in Europe in 1985 and 1986 had a profoundly adverse effect on U.S.-Europe service and TWA in particular during those years. As discussed with the GAO, TWA was forced, almost overnight, to severely cut back its operations to Europe and dramatically expand its U.S. services. We were also forced to offer low prices and discount coupons with 20% to 30% off our fares to attract passengers back to TWA. As a result, in 1986, TWA suffered its worst loss in history totaling \$250 million, excluding a sale of one-half interest in the PARS computer system. Had these abnormally low fares continued, TWA would have been in bankruptcy by 1988 if not sooner. Because these factors, among others, forced a low fare environment on TWA in 1986, any comparative use of that year as a statistical base by the U.S. Government are in my opinion particularly unfair to TWA. Although TWA in truth, became an unwitting arm of U.S. foreign policy as a result of the prominent display of our flag on our aircraft, I can assure you we at TWA will continue to display the flag and are more than proud of the association.

Consumers, as you properly asked, have every right to enjoy low fares. Who wouldn't want to pay the lowest possible price for anything? However, airlines have to earn a satisfactory profit to stay in business and only in 1987 did TWA, after great financial sacrifices on the part of its employees, actually earn a reasonable rate of return to allow us to survive in this highly competitive industry.

FARE MATCHING

Question 5. You mentioned that in the Washington, DC-New York shuttle market three carriers all charge the same \$99 fare. In a market like that, who initially establishes the fare? And if it is supposedly a competitive market, why are the fares identical?

Answer 5. We cited the shuttle markets, which are not served by TWA, as an example in which three relatively low fare competitors exist in a relatively high fare environment. Competition in and of itself does not insure low prices. Until recently, pricing had been erratic in the Washington, D.C.-New York shuttle market. This was primarily due to the unstable nature of the airlines involved—Eastern, Pan Am, Continental—each of which had different cost structures, faced financial difficulty and were struggling for improved market share. In such a market, which can command premium prices because of high business traffic demand, the new entrant (in this case Pam Am which bought New York's Air's gates and slots in 1986) is usually the pricing leader. However, all three carriers are having financial problems and must have recognized the inherently self-destructive nature of price wars in the market. Every pricing move downward was quickly matched, nullifying any price advantage. Fares are identical in this market, as is true in almost all other markets, because airlines cannot allow a competitor to offer a lower price and attract customers for essentially the same commodity. This should not be viewed as surprising since virtually all service and manufacturing firms dealing in like products tend to have pricing structures that are either the same or very close to one another.

Senator FORD. Mr. Landry?

STATEMENT OF JAMES E. LANDRY, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, AIR TRANSPORT ASSOCIATION OF AMERICA

Mr. LANDRY. Mr. Chairman, Senator Danforth, my name is Jim Landry and I am Senior Vice President and General Counsel of the Air Transport Association of America. We welcome the opportunity to discuss the subject of domestic airline hubs with the committee.

The proliferation of hub and spoke networks has been one of the most important and beneficial developments of the deregulated era. In these brief minutes, let me first summarize the very substantial public benefits of this development.

First, the airlines operate fewer, better-sized aircraft providing more service to more destinations for the consumer.

Second, the airlines place far less demand on the air traffic control system than they would if they attempted to serve all the city-pair markets with direct flights.

Third, the consumer enjoys dramatically lower fares. If the airline chose instead of hubbing to serve these markets with direct flights, it would require the purchase of many more aircraft, a cost which would have to be passed on to the passenger.

Alternatively, if it even tried to serve the markets on the old linear route basis, the aircraft would be outsized for many of the segments and you would be paying for the empty seat next to you as well as your own.

You have all heard many times of the Brookings Institution's conclusion that deregulation has meant an annual savings for consumers of \$10 billion in terms of 1988 dollars. A major part of that \$10 billion is due to the success of hub and spoke operations, the efficiencies and economies they bring to airline operations.

And don't forget the positive impact of inter-hub competition. Fares in city pairs that involved routings over hubs are highly competitive, as passengers in many markets can select from alternative routings on different carriers to reach their destinations.

We understand that the committee is particularly concerned about the situation at hubs where a single carrier dominates the market. Here let us first correct some misapprehensions.

Critics have made much of the trend toward concentration in the industry in terms of numbers of carriers. They foresee a system operated by a handful of carriers and see an end to the enormous benefits which competition has brought to the consumer. That is why in preparing for this hearing, I was pleased to be able to present the plain and simple facts depicted in chart 9 attached to my prepared statement.

Contrary to the message in everything we read, the picture with regard to market concentration in terms of single carrier domination has greatly improved since deregulation. The proportion of the industry system-wide traffic which is moving in monopoly type markets is not increasing; it's in sharp decline. In fact, from 1978 to 1987 it was cut in half.

In calling your attention to that marked improvement, I don't mean to derogate the impact which some members of the committee feel hubbing has had on airline fares paid by those of their constituents, the so-called origin and destination passengers who fly on a spoke to or from the hub but do not connect at that hub.

Here it is important to analyze the characteristics of those routes. They often are short-haul, business-oriented markets. Business travelers by definition don't have the flexibility that discretionary pleasure travelers have in adopting their travel itineraries. And there is a significant cost involved in maintaining an inventory of available seats to accommodate their needs. And simply put, short-haul markets are more expensive to serve than long-haul markets.

Moreover, the CAB's fare structure intentionally provided cross-subsidization to short-haul operations. That was one of the things that Congress intended to end with the Deregulation Act and it did. Since deregulation carriers have adjusted fares in those markets to more accurately reflect the costs they incur in them.

Over the last few years there have been occasional suggestions that fare regulations should be reimposed upon short-haul monopoly routes. We emphatically disagree with those suggestions.

You must appreciate that local passengers and connecting passengers are sitting side by side on the same aircraft, and you can't rationally allocate the costs of the service between those passengers. I was not surprised to hear Dr. Kahn say precisely the same thing just a few moments ago. He called it hopeless, I believe. Even in the heyday of its most smothering regulation, the CAB never attempted that kind of fare regulation.

In sum, then, should Congress ordain that the airlines operate half slave and half free as was tried with a spectacular lack of success in the 10 years prior to deregulation? I say the answer to that question is a resounding no.

I would be pleased to answer any questions that the committee may have.

[The statement and questions and answers follow:]

STATEMENT OF JAMES E. LANDRY, SENIOR VICE PRESIDENT AND GENERAL COUNSEL,
AIR TRANSPORT ASSOCIATION OF AMERICA

My name is James E. Landry. I am Senior Vice President and General Counsel of the Air Transport Association of America. Our member air carriers collectively operate over 97 percent of the revenue passenger miles and about the same percentage of the freight miles that scheduled air carriers fly in this country.

We welcome the opportunity to discuss with the Committee the subject of domestic airline hubs. Although hubs existed before the economic deregulation of domestic airline operations, they have become a far more prominent characteristic of airline operations during the last decade. Indeed, while the percentage of connecting passengers in our total domestic traffic has increased only modestly in that time period (24.6% to 26.8%), the on-line connection component has more than doubled, and the interline connection share of the total is only one-sixth as high as it was ten years ago (Chart 1, attached). The result of this dramatic shift has been substantial benefits for the travelling and shipping public.

The function of a hub is to provide a location at which, throughout the day, traffic is collected from arriving flights originating at a variety of locations, and is transferred to departing flights destined for a variety of locations. The result is that a passenger originating at the end of one of the spokes, usually a small-to-medium sized city, is offered more frequent and conveniently scheduled service to a great many more destinations than was offered by the traditional linear route operations in the era of regulation.

From an airline's point of view, a hub-and-spoke operation offers a far more productive use of a carrier's resources, especially its aircraft, than operating unrelated nonstop routings. It means that with any given number of aircraft, a carrier can serve many more cities. For example, if a carrier has ten aircraft available it can provide nonstop service to ten city pairs. However, if it sends them through a hub so that the passengers can connect to each aircraft, the same number of aircraft can serve 91 city pairs.

Modest increases in the number of aircraft devoted to hub service yields great increases in the number of combinations. Thus, if 20 aircraft serve a hub, instead of the ten that we assumed in the illustration above, 381 city pairs can be served. Needless to say, even if one were to hypothetically assume that sufficient numbers of aircraft were available to provide non-stop service in all the city-pair markets now being accommodated, today's—and tomorrow's—air traffic control system would quite simply be overwhelmed and, consequently, unsafe. Moreover, the benefits of such efficient aircraft utilization are not confined to the practicalities of airways capacity, but also flow to the ultimate price of air transportation to the consumer. This occurs for two reasons. Not only is an airline's total fleet cost prudently contained, but individual aircraft are more properly sized to the traffic flows over their assigned spokes. The result has been a very substantial increase in our system's average load factor since deregulation (Chart 2, attached). No longer is the passenger boarding at a small-to-medium sized city obliged to pay for an empty seat next to his or her own.

Collectively, hub-and-spoke routes have created a national air transportation system that is far more integrated than that which existed before deregulation. The rationalization of domestic routes that proponents of deregulation predicted has occurred on a scale that has far surpassed what they foresaw a decade ago. This unan-

anticipated result of deregulation has conferred very appreciable service benefits on the consumer. By way of illustration, a passenger who wants to travel from Rochester, NY, a typical middle-sized city, to Los Angeles can depart Rochester at various times between 6:30 a.m. and 8:10 p.m. He or she can select from eight different carriers, operating over seven hubs, to carry him or her on that journey. Moreover, that passenger can not only fly from Rochester to Los Angeles International Airport, but also to Burbank Airport, Long Beach Airport, Ontario International Airport, and Orange County Airport.

This plethora of air travel opportunities for the Rochester passenger would not occur without the hub-and-spoke route system. The Rochester-Los Angeles area market only generates 174 origin-and-destination passengers per day. This is obviously insufficient demand to support nonstop service between Rochester and each of the five Los Angeles area airports. Nevertheless, because of the ability of the eight carriers to collect at their individual hubs Los Angeles-bound passengers from scores of cities, the Rochester-Los Angeles passenger enjoys an abundance of service.

Hub systems create intense incentives among carriers to attract passengers to their services. Fares in city pairs that involve routings over hubs are consequently highly competitive, as passengers in many markets can select from alternative routings on different carriers to reach their destinations. This increasing inter-hub competition over the last decade is a major factor in the air travel savings that consumers have realized since deregulation.

As you are aware, the Brookings Institution has concluded that deregulation has meant an annual savings for consumers of \$5.7-billion, as measured in 1977 dollars. Expressed in 1988 dollars, those savings exceed \$10-million. Brookings has estimated that one-third of the savings is attributable to lower fares. Quite significantly, however, it has estimated that two-thirds of the savings are attributable to service improvements—the combined effects of increased flight frequencies and the reduced travel time inherent in the shift to on-line connections. We cite the Brookings analysis for two reasons. First, the transformation of the domestic operations of U.S. carriers that deregulation has brought about, one important element of which has been the growth of hubs, has produced enormous benefits to consumers. Second, although lower fares is the most often noted benefit of deregulation, service improvements—many such as those previously described as a consequence of expanded hub operations—have also created substantial benefits for consumers.

Those benefits are so substantial because, contrary to the impression that is sometimes conveyed in popular reporting about airline operations, there are so many hubs. Indeed, there are now thirty domestic hubs. One sometimes comes away from such articles with the sense that there are but a handful of fortresses that carriers have erected and that the average traveler is automatically consigned to be routed through those few hubs, no matter what the circuitry of such a routing. That is simply not the case. (Chart 3, attached) There are several hubs in every region of the country and different carriers operate them. That configuration translates into a variety of choices for the average consumer.

The other, more easily quantified and thus more widely heralded benefit from the consumer's perspective has been the widespread availability and use of discount fares. In the decade of airline deregulation, the percentage of revenue passenger miles flown at discount fares has doubled to 91% (Chart 4), and the average depth of the discounts from the applicable full fares has grown to the record level of 61% in 1987 (Chart 5). Even more impressive has been the record of the '80's, when one compares airline prices to the consumer price index (Chart 6). Since 1981, airline prices have actually fallen 10.5% while the consumer price index increased by 24.9%. If an intent of Congress in 1978 was to do the greatest good for the greatest number of American consumers, those three developments offer striking and dispositive evidence of the success of the undertaking.

That, of course, is the reflection of what has happened to airline fares in an overall sense, and the focus of this hearing is on the much more narrow subject of the experience at hub airports. As noted earlier, in terms of connecting traffic, there is a great deal of inter-hub competition. That traffic, by definition, exhibits more flexibility in adopting travel itineraries. Not surprisingly, the major share of that traffic is comprised of discretionary, pleasure travelers, and they are aggressively sought out by competing carriers with attractive, targeted fare offerings.

That predictable market-place response to the connecting service demands at competing hubs leaves one final area for analysis—the effect of hub operations upon the fares that origin and destination passengers pay, i.e., those passengers who fly on a spoke to or from the hub but do not connect at the hub. The characteristics of those routes are important to understand. They often are short-haul, business-oriented markets. Short-haul markets impose higher unit operating costs on carriers than do

long-haul markets, where greater efficiencies can be realized. Moreover, the Civil Aeronautics Board's fare structure before deregulation intentionally provided cross-subsidization to short-haul operations. That was one of the eccentricities of regulation. Since deregulation, carriers have adjusted fares in those markets to more accurately reflect the costs that they incur in them.

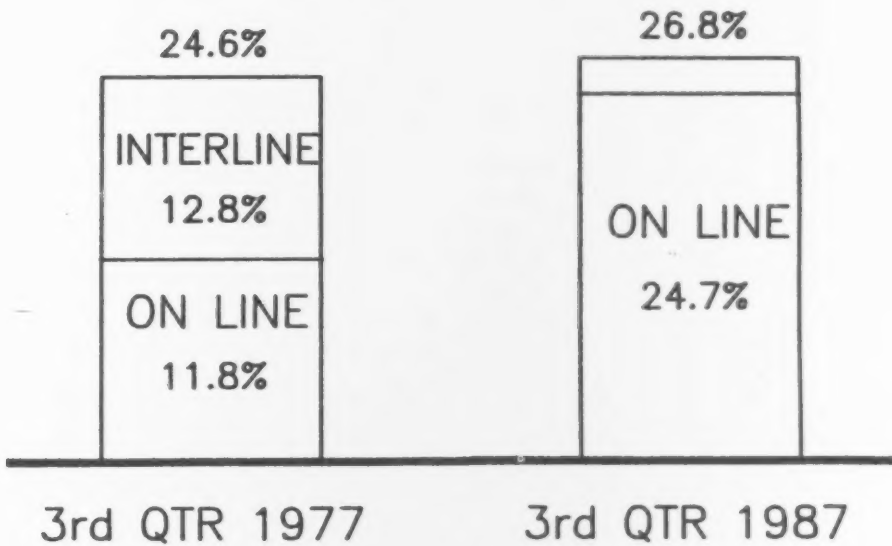
Over the last few years there have been occasional suggestions that fare regulation should be reimposed upon short-haul, monopoly routes. We emphatically disagree with those suggestions. Rate proceedings in the airline industry, in which costs were identified and rate structures formulated, were complex and remarkably imprecise undertakings. Debates were waged and judgments made over the propriety of fully allocated versus added or incremental costs. If you read the various phases of the Domestic Passenger Fare Investigation, which command the Civil Aeronautics Board's energies between early 1970 and late 1974, you will be impressed by the repeated reliance by the Board upon assumptions rather than empirical evidence as it established the multi-element domestic passenger fare structure.

The problem with such ratemaking assumptions, of course, is that they provide no assurance that the rate structure bears any relationship to the cost experience of the regulated carrier. The disparity between assumption and reality can just as easily harm the consumer as it can harm the carrier. Moreover, regulating only certain segments of a carrier's operations would only make ratemaking all the more daunting because the regulators would have to differentiate the costs attributable to local traffic from those attributable to connecting traffic. Finally, regulation creates unanticipated consequences, which can be costly to both the consumer and the regulated carrier.

Most importantly, contrary to what some of the chronic critics would have you believe, the picture with regard to market concentration has dramatically improved since deregulation. In 1978, 56.5% of our total domestic passenger travelled in markets where a single carrier had 60% or more of the passengers (Chart 7). In 1987, the comparable figure was 27.6% of our total domestic passenger traffic (Chart 8). I strongly urge this Committee to take a long, hard look at the composite comparison of the scope of monopoly-type dominance of city-pair markets in 1978 and 1987 (Chart 9)—which depicts the dramatic reduction in the percentage of our total passengers who travel in these monopoly-type markets. The proportion of the total traffic moving in these markets is not increasing, it is in sharp decline. In the face of that experience, should Congress ordain that the airlines should operate half-slave and half-free, as was tried with such a spectacular lack of success in the ten years prior to deregulation? I submit that the answer to the question is a resounding "no".

I would be pleased to answer any questions that the Committee may have.

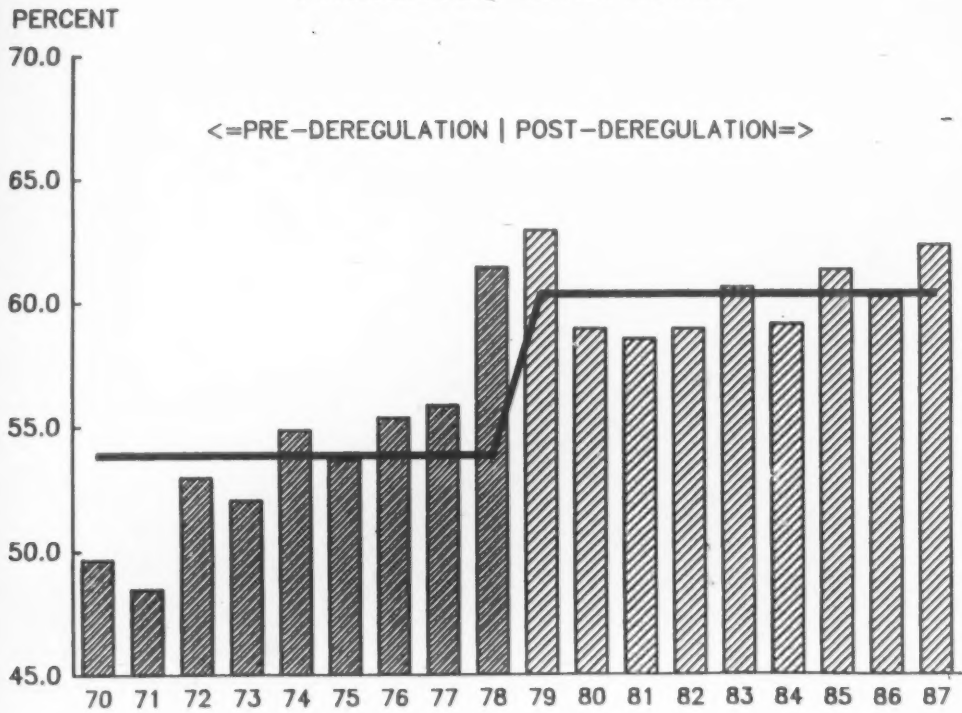
CONNECTING PASSENGERS
U.S. Domestic Operations
Percent of Total



Source: Boeing Company

Chart 2

PASSENGER LOADFACTOR



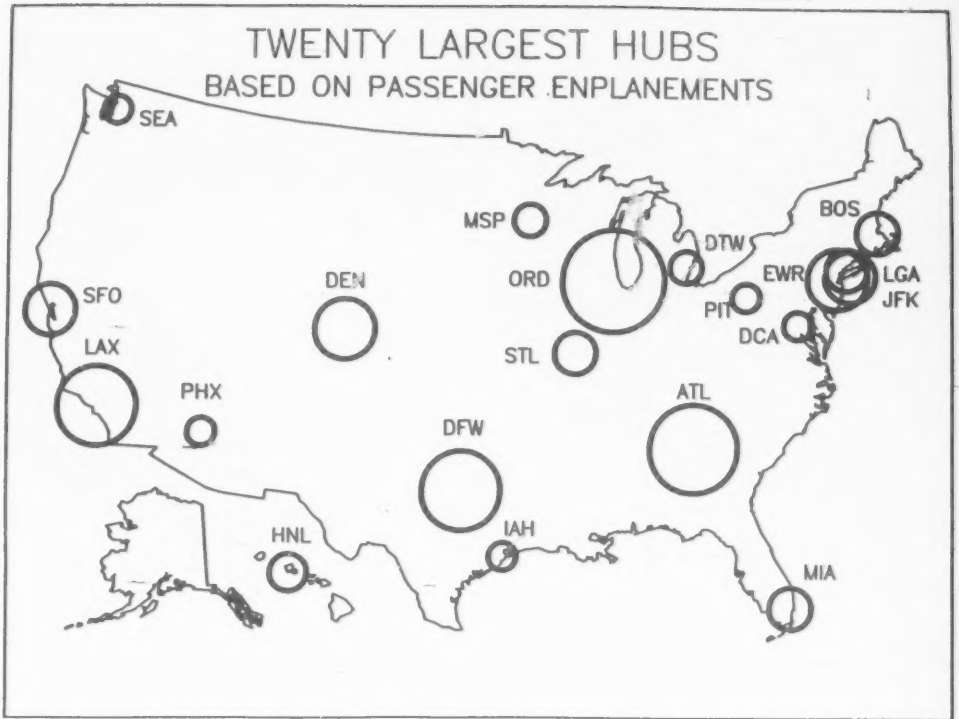


Chart 4



Chart 5

THE AVERAGE DISCOUNT FROM FULL FARE

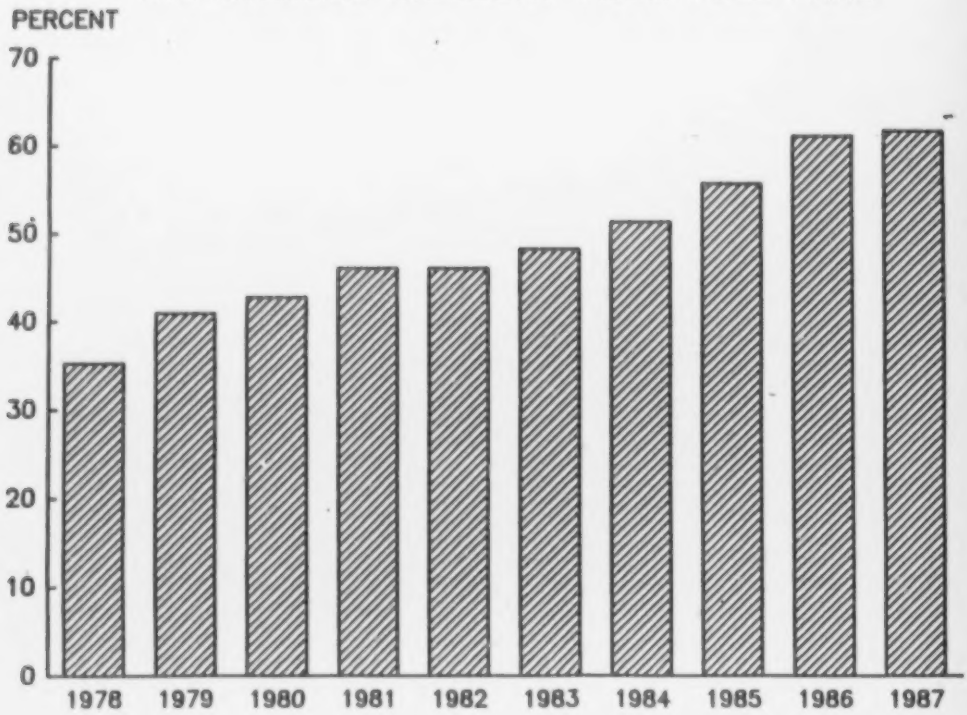
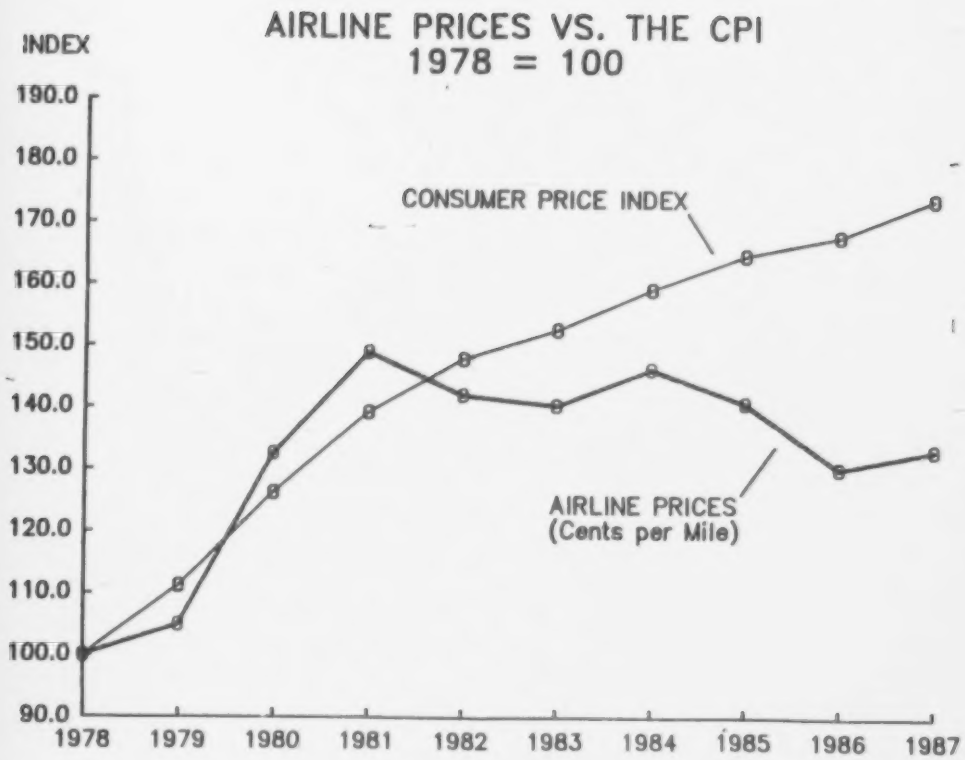
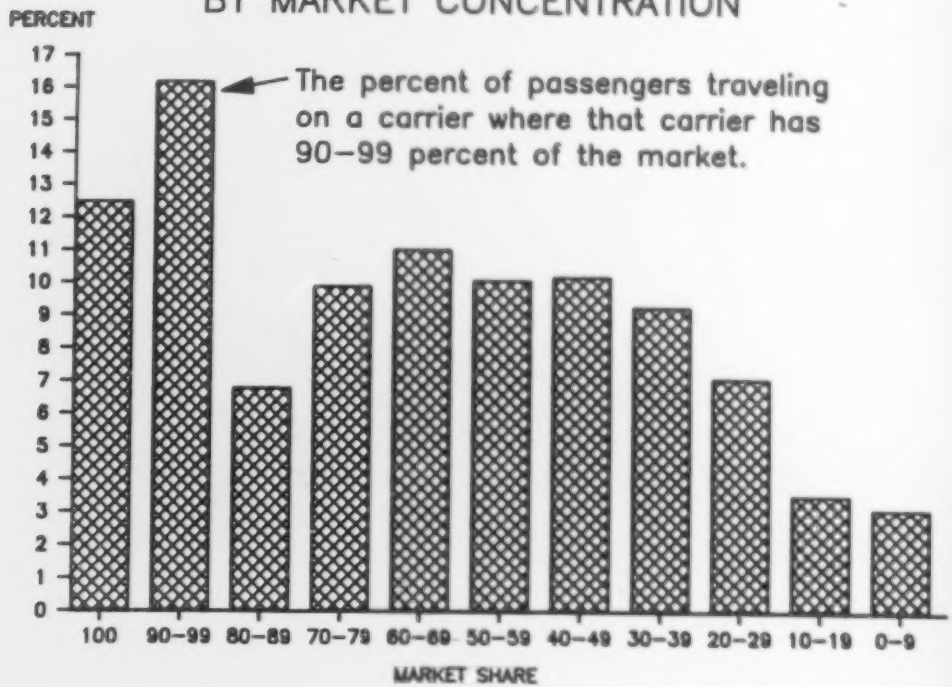


Chart 6



1978 PERCENT OF TOTAL PASSENGERS BY MARKET CONCENTRATION



1987 PERCENT OF TOTAL PASSENGERS BY MARKET CONCENTRATION

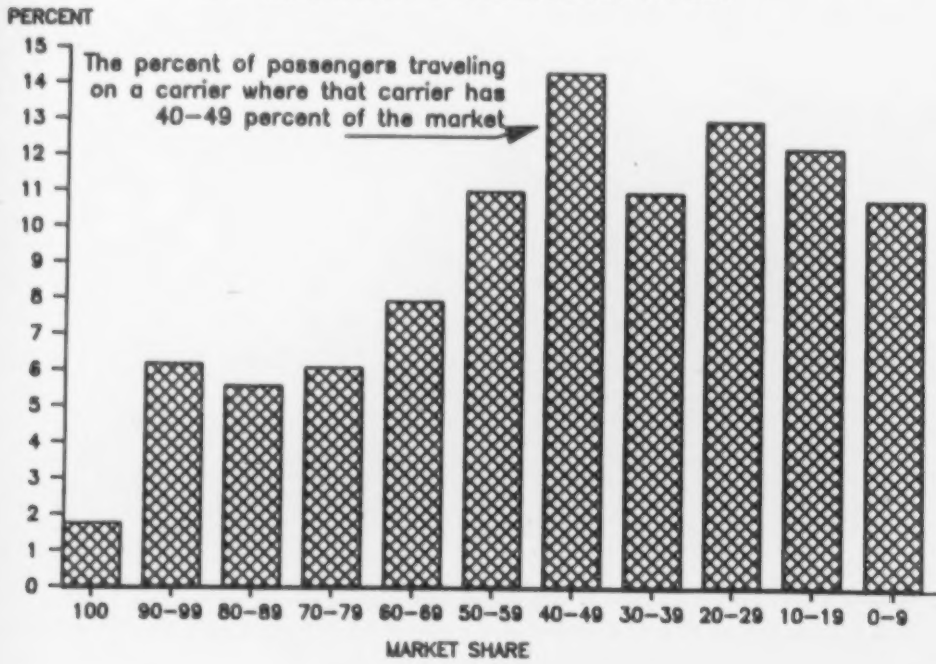
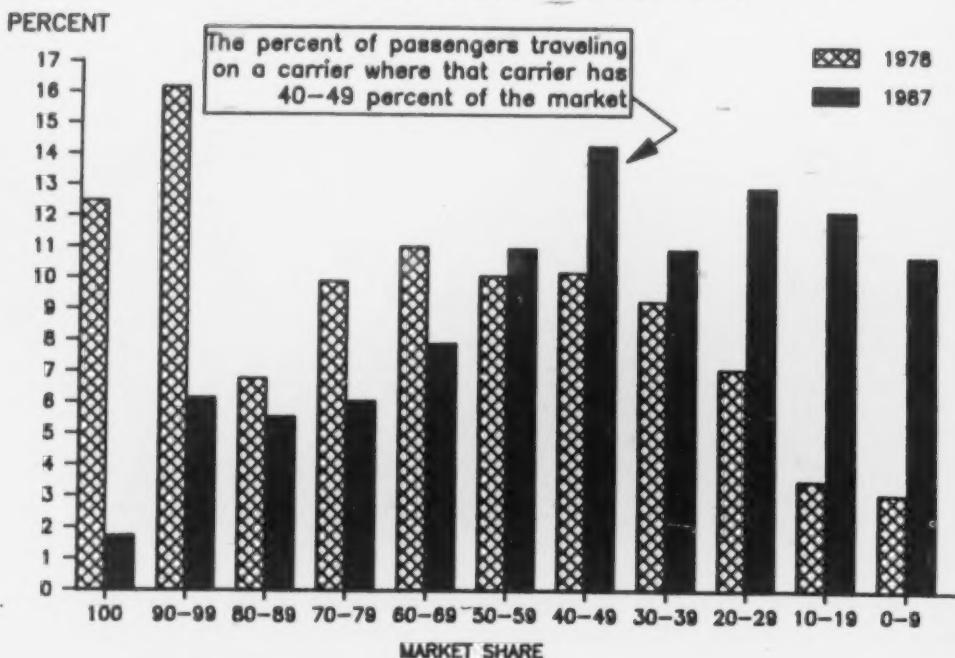


Chart 9

PERCENT OF TOTAL PASSENGERS BY MARKET CONCENTRATION



QUESTIONS OF THE CHAIRMAN AND THE ANSWERS THERETO

NEW DENVER AIRPORT

Question. 1. In recent months, the airlines have been blaming the Federal Government for not providing needed airport capacity. Now, in an attempt to alleviate delays and congestion, the city of Denver is attempting to build a new airport. Yet, the two airlines there—United and Continental—are refusing to contribute to this project. Why have the airlines taken such a two-faced position on airport expansion?

(1) Answer. You noted in your letter that the airline industry has urged that additional airport capacity be provided in the United States. You also noted that two airlines, United and Continental, have recently expressed reservations about the proposed new Denver airport and asked why "the airlines have taken such a two-faced position on airport expansion?"

The airlines have not been hypocritical in urging that solutions to airport capacity constraints be developed. Our industry is committed to supporting billions of dollars of capital improvements at airports throughout the nation. These projects will in large measure be paid for by air carrier landing fees and rental payments. Common to these projects is the matching of the proposed improvements to a reasonably determined need for the improvements. The essence of the dispute at Denver is whether a current need for a new airport, as contrasted with improving the existing Stapleton International Airport, has been reasonably demonstrated.

In examining the airline industry's reponse to capacity constraints, a distinction needs to be made between expanding capacity at existing airports and building new airports. ATA and its member airlines have always maintained that every effort should be made to generate the utmost capacity from existing facilities before plunging ahead with the construction of expensive new airports.

Common economic sense suggests this approach: the output from an existing facility should be maximized before incurring the extraordinary expense of creating a new airport. Unfortunately, this has not occurred at Denver.

The facts are that: (1) there are surplus gates and facilities at Stapleton which are under the control of Denver; (2) no airline has shown an interest in becoming a third hub carrier at Denver (there are no three-carrier hubs in the United States); and (3) passenger enplanements at Denver have decreased by more than one million passengers thus far this year and flight schedules are below levels of two years ago.

Airfield capacity enhancements at Stapleton, such as a new east-west runway, have been previously planned, actively supported by the airlines, and approved by the FAA. Denver, however, has recently abandoned pursuing such capacity enhancements at Stapleton, choosing instead to initiate the immediate construction of a new air carrier airport. Although the airlines serving Denver have questioned this decision, their actions are neither "two-faced" nor inconsistent with the policy of ATA and its member airlines of supporting the construction of new airports *wherever and whenever* they are needed.

PASSENGER FACILITY CHARGES

Question 2. The airline industry has argued for the expansion of airport facilities. Our last panel, representing airport managers, argue that the most efficient and equitable way to finance such expansion is through the use of a Passenger Facility Charge. What is your view of such a "head tax"?

(2) Answer. ATA and its member airlines oppose providing airport operators with the unilateral right to impose passenger facility charges, which are commonly referred to as head taxes.

As you know, Congress some time ago concluded that head taxes should be prohibited. It did so because of its belief that passengers should be subject to a uniform, national levy to fund the nation's airports and airways. That Congressional determination is codified in section 1113 of the Federal Aviation Act. During the deliberations leading to the enactment of the Airport and Airway Improvement Act of 1982, Congress gave serious consideration to "airport defederalization," which would have entailed terminating federal funding for many of the nation's larger airports and would have created the need to explore alternative sources of funding, e.g., head taxes. Congress, however, did not adopt airport defederalization and it made no change to the head tax prohibition.

Passengers paying an airport-imposed head tax would presumably continue to pay the federal tax on passenger tickets, which is currently eight percent of the air fare. Such an arrangement would be a double taxation of the travelling public and would be patently unfair.

In addition, the right to impose a head tax would provide airport operators with the wherewithal, at the expense of passengers and shippers, to build facilities that neither the travelling public nor the airlines needed or sought. Airport expansion projects must be coordinated and planned with the full support and participation of all parties in interest, especially airline users. As discussed more fully below, disrupting the relationship that has developed between operators and users by providing airports the freedom to levy head taxes would eliminate any meaningful discipline of the scope of and need to justify major capital improvements.

Finally, releasing airport operators from the head tax prohibition of the Federal Aviation Act would create the possibility that tax revenues generated on the airport would be used for off-airport purposes. That would be grossly unfair to the travelling public.

INCREASING COMPETITION

Question 3. Dr. Kahn has said that among other possible solutions, Congress should consider prohibiting airline ownership of computer reservation systems, as well as the taxation of certain frequent flyer credits. What are your thoughts on such actions?

(3) Answer. Your final category of questions concerns the effect upon competition at hubs of computer reservations systems and frequent flyer programs, exclusive-use agreements, and federal grant assurances. These matters are discussed below.

The advent of airline-owned computer reservations systems has generated a diversity of views within our membership and therefore we are unable to offer a consensus industry position about this issue. However, I would note that hubs have achieved prominence since airline deregulation because they are remarkably efficient collectors and dispersers of passengers and cargo; although computer reserva-

tion systems have an effect on hub operations, hubs would exist regardless of such systems.

Airlines establish and maintain frequent flyer programs to encourage and reward customer loyalty. They should not be treated for tax purposes differently than programs adopted by other industries to reward frequent customers. Retail stores hold special sales for their regular customers, and hotels and rental car companies sponsor frequent customer programs that are operated in much the same manner as frequent flyer programs. Customers in these industries are not subject to special taxation if they avail themselves of such programs. No supportable policy reason exists to discriminate for tax purposes against frequent customers in the airline industry.

Question 4. Conversely, Mr. Judy from the Miami International Airport, will argue that airline control of airport facilities—gates, ticket counters, and baggage carousels—is the single most important factor contributing to an increase of concentration at many airports. What is your view of Mr. Judy's statement?

(4) Answer. We strongly disagree with the statement at the hearing by Mr. Richard H. Judy, who is Director of the Dade County Aviation Department, that airline control under lease agreements of certain airport facilities, such as gates, ticket counters, and baggage carousels, is inimical to the consumer. No airline has been denied access to any airport, or denied the ability to establish its own hub operations at an airport, because of the existence of exclusive-use lease agreements between an airport operator and the incumbent airlines. Indeed, a notable recent trend has been the inclusion in many airport leases of provisions that enable the proprietor to direct that new entrants or incumbents seeking to expand be granted access to underutilized exclusive-use facilities, especially gates and passenger waiting areas.

Airline decisions to operate, and the extent of airline operations, at a particular airport are internal marketing decisions of each airline. Airlines have chosen to establish hub operations at different airports, recognizing the realities that market demand at any given airport is finite and that passenger connections through a particular hub are subject to alternative scheduling choices by passengers. Competition by non-hub airlines typically exists at hub airports, not only for the originating passenger, but also for the connecting passenger. A connecting passenger often has a variety of alternate, competitive hubs that he or she can choose to use.

Question 5. Following you today, Mr. Judy will urge the Congress to include in future airport grants an assurance that would preclude exclusive-use leases, or anything else that would unreasonably inhibit competitive entry to an airport. What would think you of such a proposal?

(5) Answer. Exclusive-use lease agreements are key elements in providing the security for debt financing of airport facilities and improvements, and in providing the necessary assurance to the airlines that they will have the use of airport facilities for which they have made multi-million dollar investments in purchasing aircraft, in hiring personnel, in promoting the market, and in providing tenant improvements and equipment (e.g., baggage systems and communications equipment) and support facilities (maintenance hangars, cargo buildings, flight kitchens, etc.).

As the owner and landlord of what in most instances is a monopoly resource, an airport proprietor has substantial influence not only over the operation of the airport, but also over the airport's relationship to the national air transportation system. Therefore, it is understandable that some (but not all) airport proprietors would prefer not to have to grant to the airport tenants such balancing rights as long-term leases, exclusive-use premises, and majority-in-interest provisions. Absent such provisions, however, tenants would not have the means to counterbalance the immense economic power that proprietors can wield.

We also disagree with the suggestion that exclusive-use leases should be prohibited at airports receiving federal assistance. Exclusive-use lease agreements have not, in fact, inhibited competitive entry to an airport. The absence of such agreements, however, would unreasonably inhibit an airline's decision to establish a base or hub operation at an airport because it would not be assured of the use of needed facilities to conduct its operations.

Question 6. With these issues in mind, what does the airline industry suggest needs to be done to increase competition?

(6) Answer. Finally, you ask what the airline industry would suggest needs to be done to increase competition. In general, as reflected in my testimony and in particular the charts attached to my prepared statement, we believe the experience under deregulation reflects an optimization of competition within the constraints imposed by a demonstrably inadequate infrastructure. What is needed is a major change in the historic approach to managing and funding that infrastructure. Changes must be made to assure that funding, procurement, and personnel manage-

ment procedures and policies are fully and swiftly responsive to demand. If not, over the long term the full benefits of deregulation will never be realized. The bill which you cosponsored in the 100th Congress, S. 1600, was designed to be the legislative vehicle for that essential reform. We strongly urge fulfillment of this initiative in the next Congress.

Senator FORD. Thank you very much, Mr. Landry.

Senator Danforth.

Senator DANFORTH. Mr. Chairman, thank you.

I wonder, Mr. Judy or Mr. Dunham, if you could explain to me how a dominant airline can limit the gates that another airline can acquire? I understand that there is something called a majority in interest clause. Could you explain these clauses to the committee?

Mr. JUDY. What I will do, sir, is I will try to answer that, but I won't get in the trap of not writing an answer to you. These are very complex questions because those leases extend back to the regulatory days when it didn't matter what the leases were since they originated at a time when the air transportation industry could not be classified as a utility but as luxury air transportation.

When transportation matured as a national utility, then there was a new game to be played.

Senator DANFORTH. Could you just explain to me? Is it true that—say that TWA is the dominant airline in St. Louis. Can they by terms of their agreement with the airport limit the access of other airlines to the airport?

Mr. JUDY. There is majority in interest airline control, first of all, over the ability of the local government to raise revenues in order to do something on their own. The airlines also have the landing fee structures tied into this agreement. Plus they have to approve new capacity directly or indirectly. If airports have the right to raise landing fees limited, then airport operators can't build capacity. The airlines may have a clause actually requiring their approval for the development of all new capacity.

Senator DANFORTH. Just so I can understand what you are saying, therefore, let's say that Lambert wants to increase the number of gates. Can TWA prevent that from happening?

Mr. JUDY. Under their lease agreement, they have control over the landing fees.

Senator DANFORTH. Is that true, Mr. Cozzi?

Mr. COZZI. My understanding is that TWA has absolutely no veto power versus the City of St. Louis on any carrier that would want to come into St. Louis. There are gates currently available if somebody wanted to use them. TWA used the St. Louis bond issue to fund and pay completely for its own terminals there. And if another carrier wanted to come in and absorb the same costs, I don't agree that there is any problem, as far as TWA would be concerned, for that.

As a matter of fact, St. Louis is extremely limited by having not a two parallel runway operation, as I am sure you are familiar with. There are two parallel runways, but they are not far enough apart so that if there is any fog or weather in St. Louis, you now have to close down and use just one runway. That is very unique to all of the hubs in the city.

Senator DANFORTH. My understanding is that there has been something of a running battle between the management of the airport and TWA with respect to improvements at Lambert.

Mr. COZZI. Yes. We very much want to have a second runway in St. Louis. And if another carrier were to come in and help support that, we would not be opposed to that at all.

I think the problem is that St. Louis, being such a small airport in terms of general hubs in the United States, it would be very, very difficult for another carrier to come in because the St. Louis traffic base—it's originating traffic. The people who live in St. Louis are too small to support two.

Senator DANFORTH. Let me ask Mr. Judy and Mr. Dunham is it your opinion that dominant airlines have used their power and used their lease agreements as ways of vetoing the development of the airport and the expansion of the airport and, in effect, vetoing competitors coming into the airport?

Mr. DUNHAM. In some airports that has been the case.

And, Senator, let me explain as it applies to the Dallas/Ft. Worth Airport. The majority in interest clause—I cannot sell bonds unless 55 percent of the carriers that carry the landed weight of my airport agree to it, which includes two airlines. And if they disagree to me selling bonds, I cannot build any more capacity.

Now, in my particular case, that has not happened, but in other airports it has, and that is how in the majority in interest case a dominant carrier can prohibit the airport from expanding their facilities.

Senator DANFORTH. Mr. Judy, do you have anything to add?

Mr. JUDY. No. I think that is an excellent example. I was trying to take it more on a generic basis.

The other thing that you have to couple this with—again, it is somewhat complex. But also very cleverly using the United States Congress, the airlines have legislation on the books that prevents local government independently, from collecting passenger use charges, which is one of the finest forms of taxation, and the fairest way of allocating cost to consumers. You people don't permit us to do that.

So, in Oris' case, he has the volumes of passengers to put a user charge bnvhcg in. He can go out in the marketplace, fund his facilities and build them. But airports are also restrained on the Federal level.

Senator DANFORTH. Here is really the nub of my question. If there is concentration at airports which works to the detriment of the traveling public and if the answer is not regulation, but instead opening up the airports to other carriers, do the dominant airlines in effect have a veto power right now over doing that?

Mr. JUDY. Yes, they do in general. When you look at 20 to 30 major markets that create the marketplace in this Nation, they are going to be there. They will either get us by fees or they will get us for approval of the project. If you don't have revenue, you can't do anything. And if they have to have the majority approval, you can't get it either. No matter where we turn, we don't have the independent local community right to make the decisions and take the risk on capacity.

Senator DANFORTH. They have the power to say to your airport—you're Miami. Right?

Mr. JUDY. Right.

Senator DANFORTH. They have the power to say to the Miami airport, no, you can't add gates and you can't raise revenue.

Mr. JUDY. If they don't want to approve the project, we are out of luck, no capacity.

Senator DANFORTH. And, Mr. Dunham, is that also true at Dallas/Ft. Worth?

Mr. DUNHAM. That's correct.

Senator DANFORTH. Mr. Landry.

Mr. LANDRY. Senator Danforth, I wonder if I could say just a couple of things. In the vast majority of airports in this country, the airline tenants are dealing with an airport that is a natural monopoly. The one counterbalancing device that has been conjured up so far is the majority in interest clause, that kind of approach, so that we can at least have some control over the desires and the pressures to build a Taj Mahal out there instead of what is actually necessary to serve the needs of the airlines and the consumers.

In the case of Lambert field, we are looking forward to the issuance of a master plan next year that I am sure is going to involve expansion of that airport.

Senator DANFORTH. The majority in interest clause means that what? The airlines that constitute 51 percent of what?

Mr. LANDRY. I am not sure of the actual percentage, Senator, but the majority of the traffic that is involved at that airport, and at least—

Senator DANFORTH. Controls what happens by way of construction and by way of raising revenues?

Mr. LANDRY. It ends up the airlines always are the ones who end up paying for this. We support, of course, the revenue bonds that are issued and so forth. We right now at Lambert field are supporting the land acquisition for noise.

Senator DANFORTH. But the point is that TWA controlling 82 or 83 percent—I have heard both figures—of the traffic at Lambert, now has a veto power. Whatever construction happens or whatever revenue is raised with respect to Lambert is at the sufferance of TWA. Isn't that right?

Mr. LANDRY. I wouldn't say entirely at the sufferance because, again, I have been assured by the industry that they are looking forward to a master plan that they know is going to expand that airport.

I am also told there are available gates.

Senator DANFORTH. But what I am saying is that it is my understanding that if TWA likes it, if it is an expansion that helps TWA and it likes it, then TWA says, fine, Lambert, expand it. On the other hand, if it would help a competitor, if it would bring in competition, TWA could just say, no, we're not interested. Is that right, Mr. Cozzi?

Mr. COZZI. It is our current understanding that Southwest is negotiating with the City of St. Louis today for an expansion of their facilities in St. Louis.

And America West—when the Senator left from Arizona—they wanted to enter Phoenix-New York. TWA gave them the gate at

JFK to allow them to expand. And that is a competitive route for us right out of the same terminal into Phoenix.

Senator DANFORTH. But as a matter of legal power under these contracts, TWA could say, no, we just don't want you.

Mr. Cozzi. I am not a lawyer, but I believe that the way it works—it's my understanding—is that there is some rights for the existing carriers not necessarily to limit any new entrants, but to try to review the cost structure of what they are going to build for the city.

Now, some cities—and Ft. Myers is an example—built an extraordinarily expensive terminal in Ft. Myers. And let's say our landing fees quadruple to the point where it is almost impossible to make money from Ft. Myers simply because you can't pay the cost of the terminal.

Senator DANFORTH. I understand it. I would love it too. But my understanding is that you do have that veto power. And American has it at Dallas/Ft. Worth?

Mr. DUNHAM. American and Delta both.

Senator DANFORTH. American and Delta, and both have the power to say to you, no, we don't want any—

Mr. DUNHAM. It takes both of them to agree before we can sell bonds. Now, please make sure that if a carrier comes in and wants to spend their own cash and not use revenue bonds that they are entitled to do that. And the majority in interest clause does not come forward, is not involved in that situation. But that is bringing new people in having to pay their own cash where now, as an example at DFW, we have \$1.1 billion in debt that is outstanding that everybody is paying.

Again, we have not had that problem at DFW, but there are airports that have had.

Mr. Cozzi. And just getting back to St. Louis, if I may, in St. Louis, TWA built and paid for its own terminal and, therefore, charged no other carriers for the fact that we had improved the facility. Part of the problem that I think is being discussed over here is if you improve the facility and the carrier who wants to do it can't pay for it, all the other carriers have to pay for this facility. It is shared in the landing fee basis.

Now, I am not a lawyer, but I think that is what we will find out, if I am not mistaken, gentlemen, something like that, something along those lines.

Mr. DUNHAM. Each airport, Senator, is set differently. Some, it is shared through the whole landing fee, but then the rents are charged back on that particular facility that offset the cost of that particular facility. And each individual airport has a different way of collecting those fees.

You are exactly right. At DFW the carriers do come in and have special revenue bonds that they pledge to finance and, therefore, really build their own with the airport acting as the intermediary.

Senator DANFORTH. Mr. Chairman, you have been more than generous with your time, and I appreciate your chairing this hearing. Gentlemen, I appreciate your testimony.

Senator FORD. Let me just make one observation here. The operators have one hard time. We have the off-airport fee problem. You have maintenance. You have to try to improve. You have to do lots

of things. I could see the airlines' problem that they don't want to be socked with a large expense for others to come in or to expand the airport at their expense not particularly a need of theirs.

Now, Mr. Cozzi, I would like to know why you gave up a gate to America West at JFK. I know a little bit about that airline. I read a lot about it. Now, that wasn't out of the goodness of your heart. Now, you are not a lawyer, and I'm not either. But you are the financial officer. And what was the basis of giving up a gate or a slot at JFK so America West from Phoenix could be a competitor of yours? That was awful big-hearted, you know, when you made that statement.

Mr. Cozzi. I think the way it worked out—and I am not totally familiar with the situation—is that at the time that America West requested our JFK facility, we did have some spare gates. So, it was not just out of the goodness of our hearts. I am sure we charged them some money for it.

Senator FORD. You had some spare gates and probably a pretty good contract signed with America West because they needed to break into that market.

Mr. Cozzi. Well, we also service them at the airport. We cater their planes for them at the airport. So, it is a whole series of—

Senator FORD. I understand it was not a financial turndown for you. You didn't lose anything by that.

Mr. Cozzi. No. But I can assure you. There are—I can't even think of how many carriers serve JFK, more than any other terminal.

Senator FORD. I understand that, but those carriers who do not serve JFK want to get in, and then it has to be somebody there to give up that slot. And people have been willing to buy it. Even other airports have been willing to try to buy slots so that they might be able to get a carrier to come to their community so they could go to New York. I understand all these things.

Now, we have had a pretty good working arrangement at Louisville and greater Cincinnati, which is in Kentucky. If you all have any problems, I believe we could work out something there. If you want to help generate some activity in that particular area, and if you want some small commuter airline to come into Owensboro, Kentucky, that would suit me just fine too.

So, there are a lot of us out there that are waving the flag and putting out the red letters on the ground that say "help," Nobody seems to land. They just go right over, as Mr. Kahn said. I say that with all good humor and sincerity.

We thank you for being here today and for your patience. We will now adjourn this hearing.

[Whereupon, at 12:43 p.m., the committee was adjourned.]

ADDITIONAL ARTICLES, LETTERS, AND STATEMENTS

AIR TRANSPORT ASSOCIATION OF AMERICA,
Washington, DC, October 27, 1988.

DEAR SENATOR DANFORTH: As I believe our testimony at your recent airline hub-concentration hearing, and that of the numerous other witnesses made clear, the consumer benefit of airline economic deregulation has been tremendous. At the same time, however, the national aviation policy issues confronted today are, if anything, more complex than those current at the outset of deregulation. Among these, of course, is concern over the impact of hub-concentration.

While it would be easy to rush to judgment on the basis of some popular misconceptions of airline economics and hub-concentration, you are to be commended for taking the time and effort to explore and develop a factual record upon which to evaluate these issues. We look forward to continuing to work with you in this endeavor.

In that regard, I did want to explore in a little more detail one aspect of the airport/airline relationship in which you indicated some interest—the combined impact of majority-in-interest clauses and long term airport leases. As you will recall, the suggestion was made at your hearing that these provisions somehow invited unfair competition. The simple, though thoroughly undocumented scenario presented by a few airport proprietors would have one believe that these attributes of some airport/airline relationships have thwarted development and are not in the best interest of the consumer. The facts, we believe, tell a different story.

To explain briefly, the long term lease provisions, where they exist, act as a mechanism to transfer the financial burden and risk of airport expansion from the proprietor to the airlines and ultimately the passenger. In addition, they provide the essential security necessary to justify major capital commitments by carriers to baggage handling, maintenance and related airline owned support facilities.

At the same time, these arrangements negate the natural monopoly power of the proprietor by creating alternative sources of airport space for subleasing purposes. What would otherwise be an airport in which all airlines must deal through a single vendor for space (i.e. the airport proprietor) becomes instead a multiple vendor situation giving new entrant carriers the option of dealing with either the proprietor or one of the long term lease holders.

In light of the financial exposure for the carriers and their customers given rise to in long term leases, a balance has been struck at many airports through the inclusion of majority-in-interest provisions in airport use agreements. These provisions typically involve a two step activation mechanism requiring that both a numerical majority of carriers at an airport as well as carriers representing a majority of operations or passengers at the facility agree on a particular position. In any event they do not act to "veto" airport expansion but simply to constrain the otherwise unfettered extension of the carriers' financial responsibility. Even in the case where a majority-in-interest provision is activated and a position taken, these arrangements have no control over a proprietor's right to expand a facility provided those expansion costs are not tracked back to the carriers covered by the majority-in-interest provision.

It is important to keep in mind that these lease and use provisions have developed logically as a function of balancing power at airports throughout the country. They serve an important "checks and balances" role to both prevent overbuilding and to assure sound financial development planning. As is evidenced by the attached list of current airport development projects to which various carriers are committed, it can hardly be said that these provisions, are thwarting airport expansion.

We do, of course, recognize that the dynamics at every airport in the country differ. Obviously, the situation at St. Louis/Lambert is not the same as that at Chicago/O'Hare. The fact is, however, that in neither case, nor in any other of which we are aware, is it true that any carrier has been locked out of an airport as a result of a carrier blocking capacity expansion plans. To suggest, as some airport proprietors have, that this is the case, without providing a single fact in support of this view, is in our view irresponsible.

Again, please be assured of our commitment to work with you in the development of a factual record upon which to base your analysis of current aviation policy issues. We would be pleased to respond to any further questions from you or your staff on this matter, and would welcome the opportunity to discuss these issues with you in greater detail.

Sincerely,

WILLIAM BURHOP,
Senior Vice President, Government Affairs.

Enclosure

EXAMPLES OF AIRLINE COMMITMENT FOR CAPACITY EXPANSION

AIRPORT AND PROJECT

O'Hare; \$2 billion terminal, airfield, passenger circulation, road and rail access. Project 75% complete.

Kennedy; \$2 billion "Kennedy 2000" passenger/baggage collection and distribution project.

Dulles; \$750 million-\$1 billion terminal, passenger circulation, airfield project under way.

National; \$500-\$700 million terminal, parking, roadway project about to start.

Orlando; \$400 million terminal, airfield, public parking.

Nashville; \$315 million terminal and new runway.

Palm Beach; \$160 million terminal.

Cincinnati; \$50 million for a new runway.

Charlotte; \$40 million for new international terminal and expanded domestic terminals.

LaGuardia; \$165 million for new terminal just approved.

Indianapolis; \$40 million for new runway to be completed in late 1989.

Detroit; \$500 million for new terminals and a new runway.

St. Thomas; \$82 million for terminal and airfield.

AMERICAN AIRLINES,
November 8, 1988.

HON. ERNEST F. HOLLINGS,
U.S. Senate, Washington, DC.

DEAR SENATOR HOLLINGS: Following your Committee's hearing on "Airline Concentration at Hub Airports" you asked Mr. Landry of the Air Transport Association to answer a list of questions that you had been unable to ask in person during the course of the hearing. One of your questions was the following:

"Dr. Kahn has said that among other possible solutions [to airline concentration at hub airports], Congress should consider prohibiting airline ownership of computer reservations systems. . . . What are your thoughts on such actions?"

In his reply, Mr. Landry correctly pointed out that hubs would exist regardless of computer reservations systems. However, he was prevented from responding in detail to your question because the airline relating to computer reservations systems. For this reason, I would like to respond on behalf of American Airlines whose SABRE computer reservations system is the most widely used—and the most functional—of the five systems that are currently marketed by airlines to travel agents.

DR. KAHN'S POSITION

Dr. Kahn says that separation of CRSs from airlines would "probably" serve to eliminate the "handicaps" that the present systems impose on non-CRS-owning airlines. However, he does not—either in his written statement or in his oral testimony—identify these handicaps or articulate his reasons for endorsing divestiture. We respectfully submit that anyone recommending such an extreme remedy should, at the minimum, address questions such as (a) the probable impact on CRS booking fees, (b) the likelihood of a return of display bias, (c) the inhibition on future system enhancements and innovation, and (d) the contrary views of other responsible agencies, including the Department of Justice. Since Dr. Kahn did not touch upon these questions, I propose to do so in this letter.

IMPACT ON BOOKING FEES

Mandatory divestiture would most certainly result in a substantial increase in the booking fees paid by all airlines to the new owners of computer reservations systems. Each such owner would be faced with the task of recovering substantial "front-end" capital costs in the form of the purchase price paid for the CRS and the hardware and software modifications required to convert it into a "stand alone" system (i.e. one that is divorced from the internal reservation system of the divesting airline.) These increases in booking fees would necessarily have to be passed along to passengers in the form of higher ticket prices.

DISPLAY BIAS

DOT regulations require that airline-owned computer reservations systems be free from display bias (e.g. an algorithm that gives the flights of one airline a more favorable display than those of another.) These regulations would not apply to the new CRS owners, who could be expected to reintroduce bias and sell preferential schedule displays to the highest airline bidders. Again, the passenger would ultimately be required to bear these costs.

SYSTEM ENHANCEMENTS AND INNOVATION

Today's CRSs were developed by airlines to meet airline marketing needs. They are constantly being upgraded and enhanced to provide higher levels of service to airline passengers. To put them in the hands of non-airline vendors would necessarily stifle innovation and rob these systems of the airline expertise they need for continued enhancement.

POSITION OF THE DEPARTMENT OF JUSTICE

Perhaps the most balanced view recently expressed on CRS issues is that of the Department of Justice in its letter of October 3, 1988, to Senator Metzenbaum. The Department explained that it has continually monitored CRS issues since the 1970s. In this connection, it has evaluated not only the complaints from within the industry, but also the findings of other government agencies (e.g. the General Accounting Office) and observers of the industry (e.g. Dr. Kahn.) The conclusion of the Justice Department is that CRS divestiture is an extreme remedy—that is not justified by current evidence or allegations.

We are confident that when you consider the full implications of CRS divestiture, you will conclude that such a step would create many more problems than it resolves. If you would like to explore any aspect of this question in greater detail, or would like any additional information, please let us know.

Sincerely,

GENE E. OVERBECK.

STATEMENT OF RICHARD M. KESSEL, CHAIR AND EXECUTIVE DIRECTOR, NEW YORK
STATE CONSUMER PROTECTION BOARD

The New York State Consumer Protection Board has conducted a study of the impact of airline deregulation on consumers. The study found that although the "hub and spoke" system of organizing flights had been used in a limited way for many years, deregulation has resulted in a greatly expanded use of hub airports. One airline will have flights from many different areas converge on its hub airport in a fairly brief time period so passengers can make other connecting flights. Hubs then attract commuter lines that carry passengers converging on that airport to destinations that are a short distance away. In many instances, the larger airline will affiliate with small commuter lines serving the hub, allowing the commuters to use the logo or name of the larger airline.

A major benefit of the hub system is that it has preserved service to small cities and towns, via commuter lines, that might otherwise have been eliminated as uneconomical when routes were deregulated.

The effects of deregulation on consumers, however, have been mixed. Use of hubs has led to several areas of concern: future safety of passengers, the level of competition regarding fares, and dramatic decreases in satisfactory consumer services.

There is no doubt that, viewed over an extended period of time, air travel has become safer, even including years of enormous increase in the number of air passengers. However, in spite of the overall good safety record, many experts have concerns about future safety.

While ridership was increasing so sharply, the infrastructure to serve the industry did not expand. Stress on the system has been particularly acute at hub airports.

It is a free market decision by an airline to begin a hub operation, but the decision impacts controllers at that airport, the entire air traffic control system and the airport facility itself. Although some advance notice is provided because leases and other agreements must be negotiated, the Aircraft Owners' and Pilots' Association has proposed that airlines be required to make announcements of a decision to hub and allow public comment. The FAA has indicated it supports prior notice but has not acted to require it.

The congestion when many flights converge on an airport in a brief period of time leads to further safety concerns. Controllers say they are operating under more stress than their European counterparts. Since more accidents take place on take off and landing, highly increased traffic increases risk. Reports of "near misses", incidents in which two or more aircraft come within 500 feet of one another or a pilot feels danger from proximity to another plane, almost doubled between 1983 and 1987. These indications for concern are further supported by findings of the Government Accounting Office (GAO) in May, 1987, that FAA plane inspections are uneven and inadequate, enforcement is inadequate, national standards for inspection did not even exist until 1985, and reporting by inspectors is incomplete.

I recommend that advance notice and some form of impact assessment be required before an airline establish a hub operation and that scheduling at such airports be carefully reviewed for its impact on safety. The responsibility of the FAA to assure safety was never repealed under deregulation, and scheduling may adversely affect safety. If the law must be changed to protect the lives of passengers, it should be.

When an airline establishes a hub operation, it often results in almost total domination of the airport by that airline. Consumers have found that, for travel to many destinations, there simply is no competition, as only one airline services the route. Since the rationale for deregulation was to increase competition, this is not a good result from a consumer's point of view. There has been such a proliferation of varied fare discounts that it is difficult to comparison shop. But there is no doubt that many, if not most, shorter haul trips can cost more than a transcontinental flight. While fares have generally decreased since deregulation, service to and from smaller communities actually became more expensive.

One consumer organization reported that travel agents and computer reservation systems in cities with hub airports are authorized to give discounts if passengers are steered to them. This practice may benefit some consumers in the short run, but what effect does it have on competition? Undisclosed dealer relationships between agents and airlines make it impossible for a consumer to know what the best deal for a ticket may be.

The use of hub operations should be reviewed to determine if they are leading to "de facto" geographic monopolies in some instances. Hub airports should also be studied to see if they discourage new entrants into the market by domination of landing slots, gates and access to other airport services. I agree with Alfred Kahn that airline mergers should be preceded by much more strict antitrust review when they will result in domination of a city or region by an individual airline. Further, the costs and fares of commuter lines should be examined to determine if the price increases consumers have experienced are justified.

Much has been written and said about the turmoil in the industry during this decade, and the deterioration of consumer services. Delays, lost baggage, cancelled flights, and poor disclosure to passengers about their flights are all exacerbated in the congestion at hub airports. It is hoped that incidences of these problems have peaked and that consumer services will improve. But we have a long way to go from the near chaos of a year or two ago.

The Airline Passenger Protection Act, that would set minimum standards for some consumer services, should be enacted. I also recommend that scheduling be reviewed for its impact on consumer services. It may be better to spend a little more time inside the hub airport than waiting in a plane for take off and perhaps losing one's baggage besides. The relationships between airlines, airline owned computer reservation systems and travel agents should be reviewed for anti-competitive practices. Finally, full and clear disclosure in advertising should be mandated at the Federal level. As an industry is deregulated, vigilant antitrust oversight and full disclosure to consumers are necessary in order to protect both the industry and consumers.

Thank you.

METROPOLITAN DADE COUNTY, FLORIDA

AVIATION DEPARTMENT
P.O. BOX 592075
MIAMI, FLORIDA 33159
(305) 871-7000

October 4, 1988

Senator John Danforth
497 Russell Senate Office Building
Washington D.C. 20510

Dear Senator Danforth,

This letter is to further explain the operation of Majority In Interest provisions contained in most airport-airline agreements, in response to the questions you posed at the hearing held by the Senate Committee on Commerce, Science and Transportation on September 22, 1988 regarding airline concentration. We have also taken this opportunity to further explain the nature of our concerns over the level of airline concentration at airports throughout the United States.

Majority In Interest

Majority In Interest provisions generally require that airlines carrying a majority of the traffic at an airport (typically measured by numbers of passengers) approve either any airport development project that will cost over a certain fixed amount (depending on the airport in question) or any change in the landing fees or both. Since under all but perhaps one or two airport-airline agreements, the costs of airport development are figured into the determination of the landing fee under a "residual single cash register" principle, controlling the implementation of projects and controlling changes in the landing fee are equivalent and absolute levels of control. The "majority" needed is frequently 51 percent but in some instances, such as Dallas-Fort Worth, may be 55 percent or some other similar figure.

The residual single cash register provision of Majority In Interest clauses requires that all revenues collected by an airport be first used to cover the costs of airport operation, maintenance and debt service for new and existing capacity. Only then can any additional revenues be obtained through an adjustment in the landing fee. If airport revenues exceed costs leading to a surplus, then the landing fee must be reduced. Controlling the landing fee and controlling the implementation of airport development programs have the same net effect.

The airlines defend Majority In Interest provisions by claiming that they are needed to control their exposure to the

MIAMI INTERNATIONAL AIRPORT

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risks they perceive. The air carriers claim that they guarantee the airport revenues needed to pay for the airport development, and they consider that they make the investments in airport facilities. They believe, therefore, that they should have the ability to control their exposure to competition and airport fees and charges pricing risk. The way the air carriers believe they should be able to control their exposure to the risk they perceive is by having to approve projects that will have a discernible impact on the ability to pay for such airport investments through rents and landing fees.

In reality airlines do not pay the costs of airport development--regular passengers like you and I meet those costs. The risk mentioned by the airlines whenever questions are raised relating to their right to exert direct control over not only airport costs but also airport revenues, is certainly no more than that incurred by any enterprise using public infrastructure for commercial purposes. As air transportation has evolved from transportation for the privileged few into an element of our national productive infrastructure, as vital as roads, electricity and telephones, so the latent demand for air transportation has become the guarantor of airport revenues and related debt. The evidence lies in many areas including the absence on airline balance sheets of material risk disclosure (contingent or otherwise) or any other commitment associated with airport facility leases.

With the pressures of demand clearly outstripping the availability of airport capacity for the foreseeable future it is hard to accept that having a long term lease on an airport facility is a liability. In fact in many instances it is an extremely valuable asset. Should any dominant carrier at Atlanta, Denver, Chicago, Dallas or any congested airport wish to pull out of a long term lease, there would be ranks of potential buyers three deep. This is known to the bond rating agencies which attach no per se negative financial impact to bond issues of an airport that does not enter into long term leases with air carriers. Indeed in some instances the rating agencies have seen the existence of long term leases to be a negative factor in rating the credit worthiness of airports owing to the potential of an airline bankruptcy resulting in the trustee having control over the leasehold; an empirical result which stands in conflict with the assertions of the air carriers.

Majority In Interest provisions were developed long before the evolution of air transportation into a utility and long before airline deregulation. Nonetheless, airlines have continued to find sympathy for their arguments leading to such extraordinary intrusions by the Federal Government on the proprietary rights of local governments as the Federal prohibition on the airport collection of Passenger Facility Charges needed to develop the terminal capacity for additional

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airline entry or the threat of entry. Together with Majority In Interest provisions and long term exclusive-use leases for airport facilities this leaves airports with no independent source of funding on one hand, and no independent airport development decision making ability on the other.

Airport Development Veto

The combined airline and Federal control of airport funding and development, while always a matter for serious concern, should be of particular worry today. As the concentration of air carriers at airports has risen, the number of airlines needed to veto airport development thereby preventing competitive entry under the terms of Majority In Interest clauses, has gone down.

Using the figures contained in a study by Salomon Brothers and assuming that all airports require the airlines carrying 51 percent of the passenger traffic to approve airport development projects (as mentioned earlier the figure differs from airport to airport but tends to be in the 50% to 60% range), some disturbing patterns are revealed. Looking at the eight largest airports that are not already constrained by slots under the High Density Rule, shows that at two airports one carrier alone has the power to veto airport development; in effect to veto competitive entry. At five of the remaining six airports, it takes just two air carriers to veto airport development. History shows that two carriers in a protected environment quickly learn to peacefully cohabitate to the significant detriment of the consumer. At one airport a concerted effort by four airlines is needed to veto airport development.

These eight airports are the competitive backbone of the airport infrastructure that supports the entire air transportation system. They include the major hubs in the country and the large origin and destination points that generate much of the air traffic that filters through to the other parts of the system. The level of competition at these airports by and large determines the level of competition throughout the system. The pattern for these large airports is in fact no different than that for the many other airports catering to commercial air service. As can be seen, we have an air transportation system characterized by having just one or two airlines at an airport possessing the power to thwart airport capacity development plans in pursuit of their own commercial interests without regard for the air service needs of the community or the competitive capacity needs of the national air transportation system.

Since airlines already enjoy the control of existing facilities under the terms of long term exclusive-use leases for airport facilities, the control of the process through which additional capacity can be made available for competitive entry becomes extremely important. By being able to delay or turn

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down, subtly or otherwise, airport development projects or changes in the landing fee, dominant airlines can severely limit the opportunity for competitive entry. When the need arises, airlines use Majority In Interest provisions as they are presently entitled to do, in just such a way. Quite apart from the blatant examples of one or more airlines of a Majority In Interest group controlling capacity enhancing projects, it is common for the leverage airlines enjoy to come into play in the formulation of projects before they are submitted for Majority In Interest approval. For example, we are aware of recent instances where as a condition of approval during the negotiation process it has been requested and in some instances agreed to (either in writing or otherwise) that facilities made redundant from the perspective of the Majority In Interest carrier(s) by the construction of new facilities be torn down or otherwise rendered unavailable for competitive entry. As you pointed out at the hearing, whether or not airlines have succeeded in limiting competitive entry in the past through the use of Majority In Interest provisions, they enjoy that power, face the strong motivation to use it and are not expected to, nor should they, do things out of the goodness of their hearts in a competitive marketplace.

For this reason alone, Majority In Interest agreements should be made redundant. As a practical matter, we would argue that the most effective method of achieving this aim is to have the Federal prohibition on the airport collection of Passenger Facility Charges lifted, accompanied by legislation that ensures that the revenues raised by a PFC remain outside the "single cash register" requirements of Majority In Interest provisions. This would break the presently closed loop of airport development, airport revenue sources and Majority In Interest clauses. Local governments are in desperate need of a source of funding constrained by the rigors of the marketplace instead of by the administrative fiat of the air carriers.

A further possibility which we are still in the process of examining and which would be added in addition to the repeal of the PFC prohibition, would involve the modification of the Federal obligation requiring airport operators to consult with the air carriers before implementing any airport development program. At present and in addition to the obligations contained in Majority In Interest provisions, Federal law obliges airports to consult with airport user air carriers, which is generally interpreted to be the Majority In Interest carriers, prior to the implementation of an airport development program. This provision could be modified so that consultation would involve not just those airlines holding leases at an airport which may be one or two, but instead all carriers whether holding leases at the airport or serving the airport or not. This would serve the purpose of bringing greater pro-competitive pressures to bear in a process that as it stands and given the increasing level of

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airline concentration at airports, threatens to be the tool of monopoly building. This Federal consultation requirement, as weak as it actually is, was opposed by airports aware that any such requirement is nothing more than an attempt by the airlines to legislate Majority In Interest clauses. For their part, the airlines continue to seek stronger consultation language in Federal legislation.

Concentration and Competition

All of this debate brings up the question of how it is determined whether a certain level of concentration is in conflict with the public interest. The measurement of concentration by examining market shares is the best basis we have yet developed for determining the level of competition. It is far from perfect and it is extremely important that we understand its limitations in designing policies that are aimed at ameliorating the negative impacts that tend to accompany high levels of concentration.

In particular, numeric levels of concentration take no account of the threat of entry that is a vital ingredient to the maintenance of competition. A single airline in a market may be of no anti-competitive consequence if in response to any move away from competitive pricing and competitive service offerings, other competitors come into the market. If the one carrier can, however, raise barriers to entry that make entry by a competitor either impossible or excessively costly, then the moderating competitive pressure of the threat of entry is dissipated.

In our search for barriers to entry we tend to focus on absolute barriers that physically constrain entry. The High Density Rule for example, is a physical constraint to airport access that receives an inordinate amount of attention. Were the High Density Rule to be abolished tomorrow, little change would be discernible at the High Density Rule airports since at such airports there is limited availability of gates and other facilities that are no less important to the air transportation product than the right to land and to take-off. Equally important to these physical constraints, however, are economic barriers to entry that while not prohibiting entry, make it either prohibitively costly or sufficiently costly to ensure the barrier raising air carrier with a guaranteed stream of profits above the normal level. An example of the latter of these two types of barrier to entry is the booking fees charged by computer reservations system owner airlines that amount to a penalty that non-owner airlines must pay just in order to compete against the owner air carriers in addition to the other anti-competitive effects of such systems. Computer Reservations Systems booking fees have been estimated to generate approximately \$300 million annually for the airline owner of a large system.

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In the case of airport access it is the more subtle and obscure economic barriers to entry that are commonplace. A gate, for example, may well be available for use by a new entrant airline at St. Louis but if the rental rates and other terms and conditions of airport facility use are determined either directly by the incumbent in the case of a sublease, or indirectly in the case of Majority In Interest provisions, then the new entrant faces as daunting an obstacle to overcome as the lack of a slot at one of the High Density Rule airports.

The Federal Government plays an important role in this area by tacitly condoning and indeed assisting in the imposition of the anti-competitive measures affecting the ability of a competitor to enter a market. Federal grants are approved for programs such as the construction of airport terminal "ramp" pavement surrounding an exclusively leased gates on the basis that any airline can use the "common use" ramp when in effect the exclusivity of the leases on the gates makes the ramp similarly exclusive. Another example involves the Internal Revenue Code which allows for the exclusive-use leasing of tax exempt funded airport facilities for up to eighty percent of the reasonable expected economic life of the property, when the normal limit for other similar types of facilities is five years. The longer limit for airport facilities is the result of heavy lobbying that overcame the recommendation of the Treasury for a standard five year limit. Through making an exception for airport facilities, the Federal Government has recognized the practice of long term exclusive-use leasing for airport facilities and indeed has encouraged it, making the obstacles facing those wishing to overcome the control of airport facilities, and thus capacity, enjoyed by the air carriers that much higher.

The following is a list of common historic and current economic barriers that airlines have managed to have included in airport-airline agreements or as part of long term exclusive-use leases from the earliest days of airport-airline use agreements:

- 1) As mentioned above, existing facilities made redundant by the addition of new capacity are torn down or transferred to uses of no value to potential entrants to prevent inexpensive entry by a competitor. This practice is effectively though unintentionally promoted by the U.S. Government through the approval of Federal grant funds for the construction of the new facilities that come at the price of having existing facilities made unusable by a competitor.
- 2) New facilities not immediately consumed by the existing incumbent air carriers are or were independently priced so that a competitor faces the significant disadvantage of having to include the full cost of a new facility in the price of a ticket while the incumbent enjoys the cost

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advantage of being able to average out the price of the old and the new.

- 3) Facilities are or were priced under regimes that give a significant advantage to those incumbent air carriers with many flights when compared to new entrants with relatively fewer flights. Such pricing discrimination can take a relatively overt form such as a bulk discount or other differential in the landing fee. A relatively more subtle form would be the common practice of allocating costs into fixed and variable costs and collecting an annual one-time charge to cover the fixed cost portion of the overall cost. Such pricing method allows those carriers with a greater number of flights and passengers to reduce their unit costs below those of their competitors.
- 4) Incumbent airlines controlling airport facilities are able to set sublease rates at anti-competitively high levels. If a carrier holds an exclusive-use type lease on the only or a sizeable portion of the only underutilized capacity at an airport, they enjoy tremendous power to charge uncompetitively high sublease rates for gates and other airport facilities.

These practices were lessons learnt in the post World War II period when the established schedule carriers developed airport facility charging practices in airport-airline use agreements that put the host of charter and supplemental air carriers at a crippling disadvantage leading to their bankruptcy and the removal of air transportation from the transportation choices of a huge proportion of the American public. After the demise of the charter and supplemental air carriers these anti-competitive provisions became moot. In the post deregulation era they have once again come to the fore in the competition between the airlines.

One might ask why airports have allowed themselves to become so constrained. The answer lies to a large extent in the historical development of the air transportation industry. As aviation was developing from a risky pursuit for the privileged few and while all economic aspects were tightly regulated, long before air transportation was a vital element of our national productive infrastructure, there was no need for concern over the anti-competitive aspects of airport-airline agreements. Over the years the provisions that are so detrimental to a competitive environment became ingrained as the common practice not only as far as the air carriers were concerned but also for airport managers. Local government airport interests tried hard to develop a rapport with the lawmakers but the air carriers invested heavily in all aspects of the regulatory machinery and have easily out-gunned any opposition. As a result it is only now in the aftermath of airline deregulation that the traditional

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practices of the industry are beginning to come under appropriate scrutiny but the political power of the air carrier interests remains a formidable obstacle.

Capacity

The best hope we have for ensuring that there always exists a viable threat of entry to keep prices and service offerings competitive be there just one or more carriers in a market, is to provide sufficient capacity to allow competitive, economic entry in any market. Capacity is the key to preserving the benefits of deregulation for the next generation of Americans to benefit from and enjoy. The best way of providing sufficient capacity is to free the process by which capacity is developed from those whose interests stand in direct conflict with the aim of preserving competition. The best way of doing this is to repeal the Federal prohibition on the airport collection of Passenger Facility Charges along the lines discussed in this letter, thereby enabling local governments to avail themselves of an independent source of revenue.

Conclusion

Majority In Interest provisions have undoubtedly been used to the competitive advantage of the large, established, incumbent major airlines. Together with the common practice of the long term exclusive-use leasing of airport facilities, the Federal prohibition on the airport collection of Passenger Facility Charges and the Federal requirement for mandatory consultation prior to capacity development, Majority In Interest provisions are an extremely detrimental and anti-competitive facet of air transportation, certainly no less important than the much discussed barrier to entry created by the High Density Rule and the allocation of slots.

As legislators consider the many options that will be presented to dealing with the problem of airline concentration at airports, it is important that the shortcomings of just looking at the market share measures are avoided. Preserving the intangible threat of entry should be the aim of Congressional action, and the subtleties and complexities of the factors affecting the ability of a competitor to enter a market need to be understood if we are to succeed. In this regard we have attached a letter on the issue of Computer Reservations Systems to show the many facets of one of the many factors leading to the increase in the level of airline concentration.

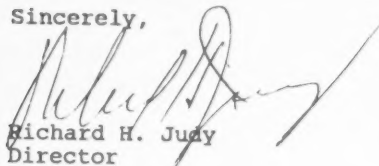
Providing sufficient capacity to maintain a viable threat of entry in every air transportation market is the key to ensuring that the benefits of airline deregulation endure for the next generation of Americans to appreciate. Repealing the Federal prohibition on the airport collection of Passenger Facility

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Charges carries the best and most equitable hope of achieving this aim.

Efforts aimed at returning air transportation to a truly competitive environment will be met with resistance from those who perceive their best interests as lying in the status quo. Should they prevail, however, we will incur huge costs for generations to come. We will forego the opportunity for the growth of air transportation and the many thousands of jobs and billions of dollars in incomes it provides. We will handicap our national productive infrastructure carrying with it the costs of imposing inefficiency on all of the industries, businesses and concerns that rely on air transportation for the transportation of their raw materials and products and employees; a cost we can ill afford in an increasingly competitive world. Lastly, we will be clawing back the great social advance made by possible by the process of deregulation once again removing air transportation from the choices available to a great proportion of Americans and giving it back to the ranks of the privileged few.

Sincerely,



Richard H. Judy
Director